DELIVERING STRATEGIC SOLUTIONS ACCA'S 2000 ANNUAL MEETING

The American Corporate Counsel Association

Delivering Strategic Solutions
Grand Hyatt
Washington, D.C.
October 2-4, 2000

Recent Developments in Taxation for the Nonprofit Organization
Session 210

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IRS Warning on Donated Car Values

The IRS recently made available an unusual type of advice (a Service Center Advice, or "SSA") concerning valuation of used cars for charitable contribution purposes. Many donors claim values listed in guidebooks, such as the Kelley Bluebook or the NADA Used Car Guide. However, donee organizations file Forms 8282 reporting sales of such cars that may occur within days of the contribution for less than the donors' claimed value. On such facts, the IRS drew two obvious conclusions: First, such sales are an indication of the value of the donated cars. Second, the fair market value of cars must be determined on a case-by-case basis and, in some cases, may have little or no relation to the amount the donee organization received upon disposing of the car.

We wonder what the Brooklyn District of IRS, which raised the question, thought about this either/or answer. One thing is certain - the IRS is concerned about car donation programs as a potential source of excessive deductions. An organization that regularly sells donated cars below deduction values claimed by donors can expect an audit and its donors can expect trouble. In extreme cases, according to this year's IRS Exempt Organization Continuing Professional Education Text, tax shelter penalties

may even be applied (to the donee, not the donor).

Seventh Circuit Takes Swipe at Tax Court and IRS, Reverses UCC Decision

United Cancer Council, Inc. v. Commissioner, 83 AFTR 2d Par. 99-416; No. 98-2181; No. 98-2190 (February 10, 1999).

In 1997, the Tax Court upheld the IRS' position that the exempt status of the United Cancer Council (UCC) should be revoked because the unique fund raising arrangement between UCC and Watson & Hughey, Co. (W&H) put W&H in an insider position and that it subsequently benefited from that position in the form of private inurement, resulting in revocation of UCC's exempt status retroactive to the effective date of the 5-year contract which began in 1984.

Now, in an uncharacteristically blunt decision, the Seventh Circuit has reversed the Tax Court and remanded the case for reconsideration on the question of private benefit, the alternative grounds for revocation of exemption asserted by the IRS which the Tax Court ignored in its decision.

UCC was in dire straits when it approached W&H in 1984. It had no assets and little income, and was losing donors to the American Cancer Society and other similar charities. W&H agreed to enter into a 5-year fund raising contract with UCC, and agreed to front the cost of the fund raising effort because UCC did not have the funds to do so. In return, the contract made W&H the exclusive fund raiser for UCC during the term of the contract, made W&H the co-owner of prospect lists developed during the contract period, limited UCC's use of the resulting lists permanently to solicitations for repeat donations, and allowed W&H to use the list in future client relationships.

Prior to entering into the arrangement with W&H, UCC's fund raising budget had never exceeded $50,000. During the 5-year term of the W&H contract, UCC expended $26.5 million, but raised $28.8 million for a net of $2.3 million.

The Court noted that the inurement clause of Section 501(c)(3) has been interpreted to require that an insider be the beneficiary of inappropriate distributions to trigger the private inurement penalty of loss of exemption. It noted that the test was functional, and that the reality of control rather than the insider's place in a formal table of organization is key. Here, the Court noted that W&H received substantial benefits above and beyond its compensation from its contract, but noted that it went to extraordinary lengths to revive UCC. Fundamentally, however, the fund raising contract was still a fund raising contract.

The Court noted that "if a charity's contract with a fund raiser makes the fund raising an insider, triggering the inurement clause of Section 501(c)(3) and so destroying the charity's tax exemption, the charity sector of the economy is in trouble." The Court acknowledged that the IRS said that not every contract makes a fund raiser an insider, but rather, the IRS said that the initial funding of the fund raising effort made W&H literally a founder of UCC or as the Court said "rather a refounder" of UCC. The IRS asserted that, as UCC's only fundraiser, W&H had UCC at its mercy and thus W&H "controlled" UCC. The Court stated that "singly and together, these points bear no relation that we can see to the inurement provision. The provision is designed to prevent the siphoning of charitable receipts to insiders of the charity, not to empower the IRS to monitor the terms of arm's-length contracts made by charitable organizations with the firms that supply them with essential inputs, whether premises, paper, computers, legal advice or fund raising services."

Breaking the arguments down to their essentials, the Court said that if providing the up front money made a fund raiser a founder, then the result would mean denial of tax exemption to any new or small charity that wanted to grow by soliciting funds. The Court made it clear that whether there was one fund raiser or ten, the fund raiser was taking a huge chance in taking on UCC as a client, and was benefited accordingly. W&H did not make repeated infusions into UCC. The fund raising receipts were placed in an escrow account controlled by W&H until its expenses had been repaid, including its up-front amount, but after that, W&H distributed funds to UCC. All of these facts were viewed as details by the Court, having nothing to do with private inurement.

The Court noted that "the other point that the Service makes about the exclusivity provision in the contract - that it put the charity at the mercy of the fund raiser, since if W&H stopped its fund raising efforts UCC would be barred from hiring another fund raiser until the contract with W&H expired - merely demonstrates the Service's ignorance of contract law." The Court went on to note that when a company is given an exclusive contract, it assumes an obligation to use its best efforts to promote the contract's objectives. W&H did so here, but had it "folded its tent and walked away" it would have been in breach of its obligations under the contract and UCC would have been free to terminate the contract without liability.

Addressing the huge amount of fund raising costs relative to funds raised, the Court noted that much of UCC's purpose for existing as a charity was to inform the public on cancer awareness. Under appropriate accounting conventions, UCC was permitted to classify $12.2 million of its fund raising expenses as educational expenditures because of the cancer information contained in the fund raising letters (80 million of which were sent out during the 5-year contract year period).

Finally, with regard to this point, the Court noted that W&H received only a modest profit after its mailing and other expenses were considered. Having observed all this, the Court said that the ratio of expenses to net charitable receipts was unrelated to the issue of inurement. Rather, as the Court noted, that issue would bear on matters not raised by the IRS or the Tax Court, specifically the efficiencies of UCC in operating its fund raising operation. Without saying UCC was efficient or inefficient, those judgement issues exercised by the board would be the context in which the ratio of fund raising expenses to funds raised should be considered, if at all. The Court noted that the charity drove the best bargain it could, based on the record, given its position. The Court stated that "maybe desperate charities should be encouraged to fold rather than to embark on expensive campaigns to raise funds. But that too is a separate issue from inurement. W&H did not, by reason of being able to drive a hard bargain, become an insider of UCC. If W&H was calling the shots, why did UCC refuse to renew the contract when it expired, and instead switch to another fund raiser?"

The Court completed its analysis of the inurement issue by saying that no evidence whatsoever of control of UCC by W&H was apparent under any legal definition of control. The Court noted "as the amicus curiae briefs filed in support of UCC point out, (the IRS action) threatens to unsettle the charitable sector by empowering the IRS to yank a charity's tax exemption simply because the Service thinks its contract with its major fund raiser is too one-sided in favor of the fund raiser, even though the charity has not been found to have violated any duty of faithful and careful management that the law of nonprofit corporations may have laid on it. The resulting uncertainty about the charity's ability to retain its tax exemption - and receive tax-exempt donations - would be a particular deterrent to anyone contemplating a donation, loan, or other financial contribution to a new or small charity. That is the type most likely to be found by the IRS to have surrendered control over its destiny to a fund raiser or other supplier, because it is the type of charity that is most likely to have to pay a high price for fund raising services. ... It is hard enough for new, small, weak, or marginal charities to survive, because they are likely to have a high expense ratio, and many potential donors will be put off by that. The Tax Court's decision if sustained would make the survival of such charities even more dubious, by enveloping them in doubt about their tax exemption."

Continuing its lambasting of the IRS' case, the Court said "we are not reassured when the government's lawyer, in response to a question from the bench as to what standard he was advocating to guide decisions in this area, said that it was the 'facts and circumstances' of each case. That is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS."

The Court noted that the line of reasoning employed by the IRS and the Tax Court would be relevant only if it were shown that the UCC Board acted sloppily in employing W&H and provided an extravagant contract without justification, things not shown here. The Court said the presence of such facts might be a route for using the tax law to deal with the problem of "improvident or extravagant expenditures" by a charitable organization, but that that circumstance still would not mean that the windfall to the fund raising organization constituted benefits to insiders, the key to private inurement.

The Court closed its opinion by noting that the Service's alternative argument of private benefit had "been given a bye by the Tax Court." In reference to that issue, the Court said, "The board of a charity has a duty of care, just like the board of an ordinary business corporation, and a violation of that duty which involved the dissipation of the charity's assets might (we need not decide whether it would - we leave that issue to the Tax Court in the first instance) support a finding that the charity was conferring a private benefit, even if the contracting party did not control or exercise undue influence over the charity. This, for all we know, may be such a case."

To test whether it is such a case, the case was summarily remanded to the Tax Court for reconsideration.

We have provided a lengthy analysis of the Seventh Court's opinion, employing liberal quotations from the opinion itself. We couldn't help it: rarely is the IRS and the Tax Court "taken to the woodshed" in language like this by an appellate court. We thought you should hear (or at least read) these blunt assessments word-for-word. What does this have to do with charitable gift planning? Directly, very little. But this is a momentous case in exempt organizations law, and since it involves contracts with fund raising firms and the eligibility of charities to receive tax deductible gifts, we felt that our readers should have a full airing of this case, to date, in CGPNews. We assume the Tax Court will dutifully reconsider the case, addressing the private benefit issue, and if and when an opinion is issued, we will bring the results to you.

Finally, how might a case of this nature be decided in the future where the IRS asserts intermediate sanctions which depend heavily on the "facts and circumstances test" summarily dismissed by this court? Only time -- and facts and circumstances -- will tell.

IRS and UCC Reach Closing Agreement

The United Cancer Council, in a closing agreement reached with the IRS, agreed that it was not entitled to exempt status from 1986 through 1989, but the IRS granted 501(c)(3) exemption from 1990 forward.

Section 501(c)(3) requires that an organization operate exclusively for an exempt purpose, that any private benefit be insubstantial, and that "no part of the net earnings" of the organization "inures to the benefit of any private shareholder or individual." The prohibition against inurement is violated when an "insider" receives excess compensation or a share of the charity's net earnings. The concept of private benefit applies when the benefit does not involve an insider but instead an outsider receives a disproportionate benefit from the charity.

Insolvent and facing imminent bankruptcy, UCC hired a commercial fund-raiser willing to advance funds. Part of the agreement gave the fund-raiser the exclusive rights to use the mailing list that would initially be generated for UCC's benefit. Over five years, the direct-mail solicitations using the list produced $28.8 million in revenue. UCC received $2.3 million of this amount and the commercial fund-raiser received $26.5 million.

The IRS revoked UCC's exemption in 1990 retroactive to 1984 after it determined that UCC had operated for the private benefit of a commercial fund-raiser (the Service asserted that the fund-raising contract was so favorable to the commercial fund-raiser that it resulted in more than an insubstantial private benefit) and that it had allowed its assets to inure to the benefit of the fund-raiser. The IRS also issued a deficiency for the 1986 and 1987 tax years. The ensuing court battle ended in 1999 when the Seventh Circuit reversed a Tax Court decision that had upheld the revocation.

Under the subsequent closing agreement, UCC was required to release a statement that it will "limit its activities to accepting charitable bequests and will transmit such bequests to local section 501(c)(3) cancer councils for use solely to provide direct care for cancer patients." Additionally, UCC has agreed not to raise funds from the general public.

Appeals Court Affirms Tough Assignment of Income Case

*Ferguson v. Commissioner, ___F. 2d ___(*4/7/99). In our May1997 issue, we described the Tax Court opinion in this case [108 T.C. 244 (1997)]. There, the Tax Court held that charitable contributions of stock made immediately before the Corporation was acquired in the tender offer produced capital gain taxable to the donors. The case challenged long-held notions of how late is too late for a contribution under these circumstances, and now the Ninth Circuit has affirmed that Tax Court opinion.

Michael D. Ferguson's family owned nearly 20 percent of the stock of American Health Companies, Inc. ("AHC"). Here is the chronology of events:

7/28/88 AHC entered into a merger agreement with CDI Holdings, Inc. ("CDI")

8/3/88 A tender offer was made to the AHC shareholders conditioned on CDI acquiring 85 percent of the AHC stock.

8/15/88 Michael Ferguson signed a "donation-in-kind record" indicating his intention to donate a 30,000 AHC shares to two charitable donees

8/16/88 Ferguson's broker help him open a new brokerage account and placed 391,651 AHC shares into it

8/22/88 A SEC filing indicated that the Fergusons would tender their stock to CDI

8/26/88 Ferguson formed a charitable foundation to receive a part of his contribution.

9/8/88 The broker arranged the actual transfers from Ferguson's account to accounts for his church and the new foundation (and Ferguson signed an authorization for this transfer on the following day)

The AHC shareholders tendered stock throughout August and September 1988. The proportion tendered reached 50 percent on August 31 and 95.2 percent on Sept. 9. CDI accepted the tendered stock on Sept. 12, and purchased the shares on the following day. Was the transfer made in time for Ferguson to avoid a capital gains tax on the shares? The Tax Court said "NO" and the Ninth Circuit Court of Appeals agreed.

Rather than propound a general principle of law, the Ninth Circuit undertook a horticultural fact-finding mission - when did the stock "ripen" into a right to receive the sale proceeds? On these facts, it simply held that, "because the Fergusons' contributions of their AHC stock were not completed until September 9, 1988 -- at least nine days after their stock had ripened, we affirm the Tax Court's decision holding the Fergusons taxable on the gain in the appreciated stock." The Tax Court opinion had stated a more general rule, reaching the same result because of the reality and substance of the events surrounding merger agreements, the tender offer, and the gifts to the charities all indicated that, prior to the date of gift, the Fergusons' ANC stock had been converted from an interest in a viable corporation to a fixed right to receive cash.

As we stated before, this case should required reading for every gift planner facing a present sale contribution transaction. Despite scrutiny by a second court, there continues to be no single event or condition that provides a bright-line test for determining whether a given contribution will or will not be sufficient to shift the tax burden from the donor to the donee. Rather, this depends upon a realistic view of all the facts. It is not sufficient to see whether the pending transfer of the property is or is not subject to a binding obligation. If you are facing such a problem, read the Ferguson decisions and then make a realistic evaluation. As so often seems to be the case, there is no easy answer.

IRS Notice 99-36. The Other Shoe Falls: IRS Follows Lead of Congress, Comes Down Hard on Charitable Split-Dollar Insurance

Charitable split-dollar life insurance legislation continues to evolve. The Joint Committee on Taxation has clarified the intent of proposed legislation concerning charitable split-dollar life insurance. Charitable gift annuities are excluded, as is reinsurance of gift annuities. Charitable remainder trusts holding life insurance policies are not necessarily included, but Treasury is given the authority to produce regulations to assure that the intent of the legislative proposal is carried out, particularly in areas where abuses of gift annuities and charitable remainder trusts are not readily apparent (but based on experience, certainly may appear in the future!). Now, the IRS has, as expected, taken a punitive position with regard to these arrangements. The exempt status of a charity participant may be challenged on private inurement or private benefit theories. The IRS threatens, where applicable, to apply an excess benefit transactions tax under Section 4958, a self-dealing tax under Section 4941, and a taxable expenditure tax under Section 4945. In addition, a charity that provides written substantiation of a charitable contribution in connection with a charitable split-dollar insurance transaction may be subject to penalties for aiding and abetting the understatement of tax liability under Section 6701. In a particularly creative but appropriately punitive measure, the IRS also will consider whether to require charities to report participation in charitable split-dollar insurance transactions on their annual Form 990s! Individuals who participate in charitable split-dollar life insurance arrangements may be hit with the accuracy-related penalty, the return preparer penalty under Section 6694, the promoter penalty under Section 6700, and the penalty under Section 6701 for aiding and abetting the understatement of tax liability. Note, message to the split-dollar guys: it looks like it’s time to fold the tent and call it a day!

If It Weren’t For Those Blasted Computers and People, The IRS Would Be Perfect

On April 30, the IRS released new actuarial tables for use in calculating the Section 7520 rate for planned gifts and other estate planning transactions. Now, in a correction retroactive to the original effective date of the new tables, which was May 1, 1999, the IRS has issued regulations correcting its errors.

Bankrupt Taxpayers Out of Money, But Not Out of Ideas

In *Re Smihula, United States Bankruptcy Court for the District of Rhode Island*, 83 AFTR 2d Par. 99-889; No. 98-13949, May 24, 1999. The law of bankruptcy and charitable giving continues to intertwine and evolve. This action, under the "The Religious Liberty and Charitable Donation Protection Act of 1998," makes it clear that some giving to charity which reflects a trend prior to a bankruptcy filing may be protected from creditors, but once someone files for bankruptcy, the debtor deciding that he or she would rather have a charity have the money than his or her creditors still doesn't work! In this case, the husband and wife who were the debtors actually made that statement!

James and Jean Smihula filed a Chapter 13 bankruptcy action on September 23, 1998, but on November 5, 1998, they filed a notice of voluntary conversion to Chapter 7, together with a motion to amend two schedules of their filing. (Chapter 13 provides for an orderly payment of a bankrupt's debts, while Chapter 7 provides for total discharge of indebtedness subject to discharge.) The original schedules showed a net income after reasonable living expenses of $865 per month. Under the amended schedules, the only change was to provide for $700 per month in charitable contributions.

The Smihulas argued that their amended action should be allowed and not dismissed as prejudicial on the basis of the statement in The Religious Liberty and Charitable Donation Protection Act of 1998 (the "Act") that "in making a determination whether to dismiss a case under this section, the Court may not take into consideration whether a debtor has made or continues to make, charitable contributions (that meet the definition of "charitable contribution" under Section 548(d)(3)) to any qualified religious or charitable entity or organization (as that term is defined in Section 548(d)(4)). The Smihulas argued that the phrase "have made, or continued to make" applied to their circumstances, arguing that "It is highly discriminatory and perhaps even unconstitutional to interpret 707(b) so as to allow an individual debtor who "found God" prior to bankruptcy and gave to charity regularly to escape payment of his debts in favor of charitable and/or religious giving, yet deny the same relief to a debtor who "found God" subsequent to seeking bankruptcy protection."

The Court ruled, however, that recent legislation and its history did not support the Smihulas position. Specifically, the Court stated that "the amendment states clearly that the Court cannot consider whether a debtor 'has made or continues to make' charitable contributions, when determining substantial abuse. This language, which needs no interpretation or construction,

requires that as of the petition date, the debtor had established a history of charitable giving. This bolsters a major purpose of the legislation: to protect religious and charitable organizations from having to turn over to bankruptcy trustees donations these organizations received from individuals who subsequently filed for bankruptcy relief. In addition, the bill protects the rights of debtors to continue to make religious and charitable contributions after they file for bankruptcy relief," (quoting from the House Report accompanying the Act). The Court noted that throughout its legislative history, the proponents of the Act had made it clear that the amendment was not intended to allow debtors to begin making charitable contributions on the eve of bankruptcy. The record reflected that the Smihulas readily admitted that the decision to make charitable contributions of $700 per month was made after the Chapter 13 filing, and the Court noted that it was undisputed that the Smihulas had actually been making these contributions after the petition was filed. The Smihulas also readily admitted that they preferred to use their disposable income for charitable purposes rather than paying their creditors.

The Court was clearly not amused by the Smihulas creative planning. It ruled that the filing was abusive, and provided that the Smihulas had 15 days to revert to Chapter 13 status for their bankruptcy action.

Family Feud: Estates Can Be Disqualified Persons Too, and Heirs Can Still Sue

LR 199917078. Some ruling requests read like a soap opera, particularly one filled with lawyers ready to litigate. In this case, H died and W sued H's estate to recover her state law statutory share of his estate. Before that claim could be resolved, W died. Then, a brother and niece of W brought a lawsuit against W's estate, contesting her will's validity. A private foundation was a beneficiary named under the wills of both H and W.

Now, the private foundation and the heirs have reached an agreement to preclude litigation. In settlement, H's estate will pay W's estate to settle her forced heirship claim. W's estate will then pay the relatives to get them to go away. Then, the remaining assets will pass to the private foundation. Noting that the estates of H and W are disqualified persons with regard to the private foundation, and the estates have filed a request asking that the IRS rule that an exception of the self-dealing rules will allow the settlement to proceed.

The IRS ruled that Treas. Reg. Sec. 53.4941(d)-1(b)(3) is applicable under these circumstances. Under this exception to the self-dealing rules, five requirements must be met. These are set out below:

1. The administrator or executor of the estate must either possess a power to sell the property involved, a power to reallocate the property to another beneficiary, or a power to require the sale of the property under the terms of any options subject to which the property was acquired by the estate.

2. The transaction must be approved by the probate court having jurisdiction over the estate or by another court having jurisdiction over the estate or over the private foundation.

3. The transaction must occur before the estate is considered terminated for federal income tax purposes as set out in Treas. Reg. Sec. 1.641(b)-3(a).

4. The estate must receive an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in the property involved at the time of the transaction, taking into account the terms of any options subject to which the property was acquired by the estate.

5. The transaction must either result in the foundation receiving an interest or expectancy at least as liquid as the one it gave up, it must result in the foundation receiving an asset related to the activity carrying out its exempt purposes, or the transaction must be required under the terms of any option which is binding on the estate.

In the instant ruling request, the IRS ruled that the five requirements had been met. First, each executor possessed a power of sale with respect to the estate property. Second, the settlement will be approved by the applicable probate courts having jurisdiction over the two estates. Third, the settlement will occur before the estates are considered terminated for federal income tax purposes. Fourth, the estate and the exempt organizations (the private foundation and others) will not give up any of the fair market value of their interests (other than as a result of the settlement of existing claims). Fifth, the interests of the estates and the exempt organizations under the settlement will remain as liquid as their interests were before the settlement.

As a result, the IRS said the parties, so determined to litigate, could instead negotiate, and if successful, settle short of the courthouse. Let's hear it for peace and harmony brought on by the IRS!

Self-Dealing Exceptions Saves Bequest of Note

LR 199924069. Treasury Reg. Sec. 53.4941(d)-1(b)(3) received a lot of work in the past month. It saved the day in LR

199917078 (see above), and it is the determining factor in this ruling. Here, the decedent bequeathed a note to the foundation where the decedent was the payee and the payor was a partnership of which the decedent was a member, thereby making it a disqualified person. However, the previously mentioned Treas. Reg. Section came into play in this transaction as well. The IRS noted that where that exception applies, a second exception, governing loans by disqualified persons, also applies. This exception is found in Treas. Reg. Section 53.4941(d)-2(c)(1). Consequently, the bequest of the note did not create a self-dealing transaction.

Charitable Lead Trust Completes Hat Trick: Produces Income Tax, Gift Tax Charitable Deduction and Reduces Generation-Skipping Transfer Tax

LR 199922007. Charitable lead trusts are great vehicles for transferring assets from one generation to another, and they are also great vehicles for obtaining income tax charitable deductions when a lead trust is a grantor trust for income tax purposes. Generally, these two goals are inconsistent with each other in practice, since a grantor trust for income tax purposes, while producing a nice income tax deduction upon the initiation of the trust, requires the grantor to report all income of the trust as his own during the term of the trust even though it is paid to the charity in satisfaction of the charitable lead trust obligation. For a grantor trust intended to obtain the income tax charitable deduction, using tax-exempt bonds as the principal obtains the deduction without producing taxable income to the grantor during the trust term. However, because rates on tax-exempt bonds are so low, in a trust intended to obtain a gift, estate and/or generation skipping transfer tax deduction, a much higher rate of income is typically desired. This inconsistency typically means that these vehicles are not ordinarily combined.

However, more and more in recent years, a trust which produces both the income tax deduction and the transfer tax deduction is being utilized. This so called "super trust" would seem to be of dubious value for the purposes stated above, but there are economic circumstances which can make the combination work. In these instances, it is necessary for the trust to be a grantor trust for income tax purposes but not for transfer tax purposes. Consequently, a grantor trust power under Sections 671-679 of the Internal Revenue Code must be utilized. In this ruling request, the donor intends to create a grantor trust for income tax purposes, but intends to obtain the transfer tax deduction for gift, estate and generation skipping transfer tax purposes. The trust will be a charitable lead unitrust paying a 5% unitrust amount for 10 years. At the end of 10 years, the trust principal will pass to grandchildren. The trustee of the lead trust is a bank, and a beneficiary of the charitable lead unitrust will be a family foundation headed by the daughter of the grantor.

The income tax grantor trust power utilized in this trust is a common one in these circumstances. Specifically, the taxpayer will have the power, in a nonfiduciary capacity, to reacquire or exchange any property of the trust by substituting other property of equivalent value to that of the replaced principal within the meaning of Section 675(4)(C). The taxpayer posed 8 issues in the ruling, but the most important was the first, relating to the income tax grantor trust rule. The requirement that the power to exchange property be exercised only in a nonfiduciary capacity is set out in the instrument. However, the IRS still maintained that the facts and circumstances at the time of such a transaction would control on this issue, and that a factual determination would have to be left to the applicable district director and subsequent examination of the grantor's income tax returns. The IRS did rule, however, that if, in fact, the power was exercised only, if at all, in a nonfiduciary capacity, the trust would be a grantor trust for purposes of Section 675.

The other ruling requests sought the usual assurances regarding exclusion of the trust assets from the estate for estate tax purposes, and other such matters. A key to the estate tax exclusion issue was the representation by the taxpayer/father that he would assume no leadership position with regard to the private foundation benefiting from the trust. Should he do so, the assets would potentially be includable in his estate because of a retained power to control their use by the designated charitable beneficiary, i.e., the family foundation.

Note that the actual exercise of the power to exchange assets, would constitute an act of self-dealing. Ah, sweet fiction. . . .

The Accuracy of That Appraisal Really Does Matter

Kellahan v. Commissioner of Internal Revenue, T.C. Memo 1999-210; No. 22540-96 (June 23, 1999). Here, a donation of real estate was acknowledged to have been overvalued in the donor's appraisal in the Tax Court proceedings. Even in the face of the confession, the donor was hit with an accuracy-related penalty of 40% of the tax underpayment.

In this fact-intensive case, an experienced real estate professional ended up with the ownership of a private, man-made canal. The taxpayer never visited the property before or after acquiring it, until one month before the trial. However, he had special knowledge of real estate in the area, and the tax foreclosure proceedings by which he succeeded to ownership of the property. He was advised upon acquisition of the property that the 28 surrounding lot owners were very disgruntled that the canal was being treated as separate property and had been conveyed. The South Carolina Public Service Authority (SCPSA) advised the

donor that his best course of action, in light of the disgruntled landowner's complaints, would be to contribute the property to the SCPSA. The taxpayer did so.

In valuing his deduction, the taxpayer determined from a licensed contractor that it would cost $107,134.50 to dig a comparable canal. Additionally, he obtained an appraisal that the canal had a value of $111,750.

The IRS, however, felt differently about the value of the property. It valued the property at $5,950.

The Court analyzed the appraisals offered by both the IRS and the taxpayer, and found them both wanting. It felt that comparables of private ponds to the canal, used by both appraisers, were inappropriate. While the owner of the pond may restrict access, everyone involved agreed that the owner of the Canal could not restrict access by the public via Lake Marion. This dramatically reduced the value of the Canal in the view of the Court. The failure of the appraisals to address the publicly accessible canals issue rendered the appraisals unreliable in the view of the Court.

Furthermore, the taxpayer included in the valuation of his property several piers constructed by the lot owners surrounding the canal. Implicit in the appraisal conducted on behalf of the taxpayer was a conclusion that the taxpayer owned the piers as part of the canal. However, there was no support for this premise.

Another defect lay with the valuation of a strip of land between the ordinary water level and the high water level of the Canal. The land was valued, subject to a discount deemed inappropriate, as if it were another lot in the area, failing to take into account that it was subject to flooding at any time, should the SCPSA choose to "open the flood gates." Consequently, it could be used neither for residential or agricultural purposes.

However, perhaps the determinative issue was the position taken by the IRS, which the Court accepted, that the lot owners would pay nothing for water access through the Canal and that the lot owners would sue any owner of the strip of land included in the Canal proper who sought to restrict their water access. Without deciding whether South Carolina law gave the adjacent lot owners easements with respect to the Canal parcel, the Court found it sufficient for its purposes to conclude that there was a significant risk that such was the case. The Court believed that it was obvious that whatever property rights were conveyed with ownership of the Canal parcel were subject to significant litigation hazards which were not considered in the taxpayer's appraisal.

The taxpayer also lost when it came to the accuracy-related penalties under Section 6662(h) for both the year of gift (1990) and year 1992, the year in which the carryover after the application of percentage limitations was utilized. The taxpayer was found to have employed a substantial valuation overstatement with regard to the donated property. That provision applies when an overvaluation of 400% or more is utilized in a tax return, and where the substantial overvaluation overstatement exceeds $5,000. While the valuation penalty can equal 20% or 40% of the amount involved, if both the 400% threshold and the $5,000 threshold are crossed, the 40% rule applies. The reasonable cause exception in Section 6664(c) was found to be unavailable here because of the extensive experience of the taxpayer with regard to real estate matters and with regard to the process by which this property was acquired indirectly through a tax foreclosure. He is consequently charged with sophistication in real estate matters. He was already negligent in failing to inspect the property himself until one month before the trial in the Tax Court. Consequently, no "good faith investigation" of the value of the contributed property occurred.

Mutual Fund Shares Get Respect, Are Treated as Qualified Appreciated Stock

LR 199925029. Section 170(e)(5)(B) of the Code provides that "qualified appreciated stock" is eligible for a full fair market value deduction when contributed to a private foundation. Qualified appreciated stock is stock traded on a public exchange without restrictions, shares of which given to charity by the donor and those related to him have not cumulatively exceeded 10% of the outstanding shares of the corporation.

Now, this ruling poses the question of whether or not mutual fund shares can constitute qualified appreciated stock. The IRS' answer is: yes.

U.S. Deduction for Foreign Estate

LR 199925043 - Mr. D. was a citizen resident of Country X (let's call it "X-Land"). [Warning! - this item should not be attempted by the alphabetically challenged!] Mr. D was not fluid in the language of X-Land (X-Landish), but rather spoke and wrote in the language of Y-Land (Y-Landish). His attorney also spoke Y-Landish, and D's will was drafted in Y-Landish. At the time of his death, D owned U.S. securities, and his will provided a charitable bequest of $1,000,000 to be funded with these securities.

Unfortunately, D's will did not make it clear what charity was to receive this bequest. The funds were to be used to construct a building in Country X for use as part of a hospital operated by Charity B, but Charity B also had a U.S. Affiliate, and it wasn't clear which of these entities was the intended beneficiary. Under the estate tax law applicable to nonresident, non-U.S. citizens, an estate tax charitable deduction is allowable only for bequests to U.S. domestic entities. [By contrast, estates of U.S. citizens and residents are granted a charitable deduction for both foreign and domestic donees.] Did D intend to leave this $1,000,000 bequest to B or to B's U.S. Affiliate?

Representatives of D's estate petitioned the appropriate court in Country X to construe the will. The court had the will translated from Y-Landish to X-Landish and concluded that the bequest was intended to benefit the U.S. Affiliate of B. On audit of D's estate tax return, the Internal Revenue Service ultimately agreed with this conclusion, (but not until the will was translated into English from both X-Landish and Y-Landish). While the names used in the will did not match perfectly with either Charity B or its U.S. Affiliate, the Internal Revenue Service concluded that "consistent with the Country X court" D probably intended to leave his bequest to the U.S. affiliate, since he had been advised that the Affiliate could accept the bequest free of U.S. tax, while a bequest to B would be reduced by taxes.

The moral of this story is a familiar one. Law school professors often admonish their students to express themselves clearly: "Say what you mean; mean what you say" is a familiar refrain, even if it is not always remembered in practice. Here, despite the language barriers, D's will could have and should have stated clearly that the U.S. Affiliate was the intended legatee, thereby avoiding both of the Country X court proceeding and this IRS issue.

Easement Gift to School Board Is Deductible

LR 199927014. Two trusts own a parcel of farmland that has been used by the trustee's family for 50 years. The trusts now propose to convey to the local school board a conservation easement over 7.5 acres of a lake located on that parcel. Under the easement, this 7.5 acres will be restricted to be used solely in its current natural condition. The school board intends to construct a high school on land it owns near the lake and, with this easement in hand, will be able to use its entire property for the new high school. Without the easement, local water regulations would require the school board to devote part of its land to flood control measures.

The ruling describes highly detailed factual considerations that demonstrated how the proposed easement will preserve open space pursuant to a clearly delineated governmental conservation policy and yield a significant public benefit. On this basis, the Internal Revenue Service found that the easement was a qualified conservation easement under Code Sec. 170(h)((5)(A). Although a school board is an unusual recipient for a conservation easement donation, it was found on these particular facts to meet the standards in the regulation to be a "qualified donee."

While this ruling includes more than most readers want to know about water management and storm drainage regulations, etc., it nevertheless provides a helpful roadmap for the planner who is not familiar with the conservation easement rules.

Private Foundation May Pay Certain Expenses of Its Members

LR 199927046. A private foundation has a Board of Trustees elected by its members, who are all lineal blood descendants of the foundation's creator. The programs of the Foundation are aimed at producing "a salutary impact on national or international problems or public policy areas." In recent years, the members have had differences of opinion as to how program areas should be selected for the Foundation. Rather than split the Foundation into three or four new foundations, the Foundation proposes an internal reorganization, enabling members to participate more directly in the awarding of grants.

Under the new plan, members will play a much more active role in considering proposed grants. Because the members are widely dispersed across the country, they will necessarily incur travel expenses, as well as office expenses in fulfilling their new obligations. Consultants and other experts will have to be retained to assist the members, and these costs, as well as the costs of travel and other members' expenses will be paid by the foundation.

The Internal Revenue Service held that the services to be performed by the members of the Foundation will qualify as "personal services" within the meaning of Code Sec. 4941(d)(2)(E), and are reasonable and necessary to carry out the Foundation's exempt purposes. Therefore, the expenses of the members will incur in performing these services may be reimbursed (provided they are not excessive) without violating the prohibition on self dealing.

It may be worth noting that, while the Foundation's board traditionally met three times each year, the reorganization calls for one combined annual meeting of trustees and members. The IRS ruling specifically holds that the members' expenses "including the expense of attending one annual meeting per year" are reasonable and necessary. This underscores the need for realistic assessment of such expenses and their logical relationship to the work of the Foundation.

New Fundraising Idea - Sue the Donor!

Sierra Club Foundation v. Graham, California Court Of Appeals No. A078387 (June 10, 1999). The court itself said that this case had a "stranger than fiction flavor." and we have to agree. In short, the case found a California charity in the unusual position of suing a former donor for money damages, and winning BIG.

In 1970, Ray A. Graham III contributed stock to the Sierra Club Foundation to be added to a fund ("Frontera") primarily for conservation projects in New Mexico. Although several parcels of land were investigated, none was ever purchased. In 1980, at the request of the Foundation, Mr. Graham and Frontera consented to the release of the conditions on his gift, allowing it to be used for the general support of the Sierra Club.

Now we flash forward to 1989, when the Foundation and Mr. Graham owned adjacent parcels of land in California, and a deed survey revealed that there was an overlap of 1.884 acres. Mr. Graham asked the Foundation to deed the overlap to him, in order to resolve dispute over a land development project. When the Foundation refused, Graham filed suit in federal court in California claiming a breach of fiduciary duty. Later he caused a separate accounting action to be brought by the New Mexico Attorney General in a state court in New Mexico. The California federal action was eventually dismissed (after several procedural skirmishes) and the New Mexico case was later settled (at a cost to the Foundation of some $900,000).

Mr. Graham, apparently still bitter about these disputes and the use of his earlier contribution, and particularly angry with one Foundation official, implemented a "media strategy" aimed at discrediting the Foundation. This occurred at a time when the Foundation was conducting a special fundraising campaign for the Sierra Club's 100th anniversary. For example, Articles in newspapers and magazines appeared with titles such as "Sierra Club Misused $100,000 Donation, Suit Says." The result, the court found, was to raise questions in the minds of potential donors and this adversely affected the Foundation's ability to raise funds.

This prompted the Foundation to sue Mr. Graham alleging malicious prosecution in the California federal action. The trial court found that Mr. Graham did not have a "good faith belief," in most of the essential allegations of his complaint, and that he had acted with malice. The appeals court agreed, and upheld the judgment amounting to $672,638.07 in compensatory damages and $2,017,914.21 in punitive damages.

This (fortunately) isn't a routine case, but there may nevertheless be a lesson or two here. First, and to no one's surprise, donee organizations normally treat their donors in such a manner that they are unlikely to bring such lawsuits. There is nothing in the case to suggest that the Sierra Club did anything questionable, but we all know that a satisfied donor is unlikely to undertake a legal vendetta of the sort described in the case. When the donor is happy, everyone is happy. Second, the case is a reminder to donees and donors alike that litigation can have unexpected results, particularly with a jury in the picture.

IRS Says OK in Two Fraternity House Refurbishment Rulings

Two recent rulings offer different solutions to a standard gift-planning situation - how to give donors a charitable deduction for contributions in support of fraternity house renovations. Because fraternities are social clubs, classified under Code Sec 501(c)(7), rather than section 501(c)(3) charitable entities, such deductions are not directly available.

LR 199929050. Alma Mater College has only a limited amount of suitable housing for its upper-class students. There are six national fraternity chapters on campus, all of which have houses in which upperclassmen may reside. The college owns the property on which the fraternity houses are located, although the fraternities own the houses. For many years, the college has relied upon these fraternity residences to house a substantial number of its students. However, over the years, the condition of the fraternity houses has deteriorated so much that they no longer constitute safe and proper student housing.

To help correct this situation, the college is undertaking a fund-raising program to defray costs of renovating, acquiring and operating the fraternity houses. The fraternities will transfer title to their houses to the college, which will end up holding clear title to both the houses and the underlying land. The college will renovate the houses and lease them back to the fraternities for a renewable five-year period. To aid its fund-raising efforts, the college will permit donors to express a preference as to which fraternity house their contribution will be used to renovate. Although the college will attempt to honor these preferences, it alone retains full authority over all contributions and will be able to use them as it sees fit. About fifteen percent of all contributions will be used for the expenses of the fund-raising program. Disbursement of funds for the fraternity house projects will be overseen by a committee established by the college.

On these facts, the IRS held that the college's fund-raising program would not adversely affect its adverse tax status. Moreover, IRS ruled that donations for the fraternity house projects will be treated as donations to the college, and thus will be fully deductible charitable contributions. Despite the rights of donors to suggest that their contributions benefit a particular fraternity house, the college retains full ownership of the donated funds and will have full control of their use.

Another fraternity house renovation project with a different approach was approved in LR 199933029. Here, a fraternity house

("Chapter House") listed on the National Register of Historic Places was located on the edge of University campus on a heavily used public thoroughfare. The house is a significant example of a particular architectural genre and has been featured in articles, books, and museum displays. It has been used for educational purposes by the University's school of architecture for educational purposes, and unrelated groups have used it for lectures and other gatherings.

Three other organizations propose to cooperate in a program to preserve and conserve the facade and certain interior elements of the fraternity house. Chapter House is owned by Housing Corporation, a section 501(c)(7) organization. Landmark, a public charity that is part of the University and is devoted to architectural and historical preservation, owns another building constructed by the same architects. And Foundation, a section 501(c)(3) charitable and educational organization, is eligible to receive deductible charitable contributions. Under the proposed plan, Foundation will raise money and enter into a grant agreement with Housing corporation and Landmark for maintenance of the fraternity house, and Housing Corporation will grant a preservation and conservation easement in the affected portions of the house to Landmark or another qualified recipient. The grant agreement requires Housing Corporation to develop detailed plans for the maintenance work, with the assistance of Landmark, and to submit them to Foundation for review. Any contributions raised by Foundation from fraternity alumni or others will be expended, whether for this project or otherwise, at Foundation's sole discretion, and donors will be so advised.

The Internal Revenue Service held that contributions by fraternity alumni and others to Foundation for the proposed Chapter House project will qualify as charitable contribution deductions under section 170, subject to the usual charitable contribution rules and limitations. The ruling was specifically conditioned on Housing Corporation granting a preservation and conservation easement in the facade and the affected interior portions of Chapter House to a qualified organization under section 170(h) and section 1.170A-14(c) of the Income Tax Regulations.

Revenue Ruling 60-367, 1960-1 CB 73, was cited as authority for the holdings in both of these letter rulings. For more details, consult Rev. Rul. 63-367.

CRT Can Provide Discretionary Distributions to Charity

LR 199929033. A charitable remainder annuity trust instrument directs the trustee to pay an annuity to X for life in quarterly installments. The trust also states that any trust income in excess of the required annuity is payable to a named charity. Although the instrument doesn't specifically authorize distributions of principal to charity, it does provide that the adjusted basis of property distributed to charity during X's life must be fairly representative of the basis of all trust property available for distribution. On these facts, the Internal Revenue Service held that the trust could be reformed to permit the trustee to distribute up to a stated dollar amount from principal to charity annually during X's life, provided that the remaining trust corpus is at least a stated amount. [Sorry, that's the way rulings are written - no amounts are given.] This reformation was held not to disqualify the status of the trust as a charitable remainder annuity trust under Code Sec. 664(d)(1).

Note that the regulations specifically authorize such corpus distributions in sections 1.664-2(a)(4) [for annuity trusts] and 1.664-3(a)(4) [for unitrusts] as follows:

"The governing instrument may provide that any amount other than the [unitrust amount or annuity amount] shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment."

This is something to keep in mind where a donor finds it important to be able to transfer additional amounts to charity. Note that the donor does not receive any additional charitable contribution for amounts of corpus distributed to charity.

Option Technique Avoids Self Dealing

LR 199930048. An often-encountered situation is that of a family business which the family envisions somehow passing to younger generations' family at little or no estate or gift tax cost. This ruling demonstrates a standard technique for achieving both of these seemingly inconsistent objectives.

A father created a private foundation and, when he died, his will left it certain timber properties. A family holding company, which was also a substantial contributor to the foundation, had previously entered into an option agreement with the deceased father permitting it to purchase those timber properties at their fair market value. The transaction would be submitted for the approval of the probate court having jurisdiction over father's estate.

The Internal Revenue Service held, under regulation 53.4941(d)-1(b)(3), that the estate's sale of the timber properties by the estate to the family holding company will not be an act of self-dealing, even though the decedent's will bequeathed them to the family foundation. Under that provision, the term indirect self-dealing shall not include a transaction with respect to a private

foundation's interest or expectancy in property held by an estate or revocable trust, provided five tests are met -

(1) The executor or trustee either --

(a) Possesses a power of sale with respect to the property,

(b) Has the power to reallocate the property to another beneficiary, or

(c) Is required to sell the property under the terms of an option subject to which the property was acquired by the estate or trust;

(2) The transaction is approved by the appropriate court;

(3) The transaction occurs before the estate is considered terminated for Federal income tax purposes;

(4) The estate or trust receives no less than the fair market value of the foundation's interest, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(5) The transaction either -

(a) results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(b) results in the foundation receiving an asset related to its exempt purposes, or

(c) is required under the terms of any option which is binding on the estate (or trust).

This inter vivos option technique is a useful device for arranging sales to related parties where the bulk of an estate is transferred to a private foundation (including, for this purpose, a charitable remainder trust or charitable lead trust).

IRS Erects Stop Sign For "Son of Accelerated Charitable Remainder Trust"

As many of you will remember, only a few years ago, some creative (as opposed to ethical) people in the planning community came up with a nifty technique for manipulating the four-tier system of taxation for charitable remainder trust distributions so as to artificially recast capital gain income as tax-free return of principal under tier four. This abusive vehicle, known as the "accelerated charitable remainder trust," was attacked by both the Internal Revenue Service and Congress. Congress, acting in 1997, set a ceiling for a unitrust percentage of 50%. The Internal Revenue Service, acting through the final regulations issued last December, established bars to the abuse by requiring certain standard charitable remainder unitrusts and certain charitable remainder annuity trusts to distribute required payment amounts in the year for which the payment applies, as opposed to within a reasonable period after the end of the year in question.

However, creativity being evolutionary, a variation on this technique has arisen which the actions of Congress and the Internal Revenue Service did not address. Now, on October 18, the IRS issued new proposed regulations to address the "Son of Accelerated Charitable Remainder Trust." Under these regulations as proposed, the new technique would be thwarted by requiring that any tax-free return of principal under the four-tier system be treated as a pro rata deemed distribution of appreciated assets where the targeted abuse is present. The abuse, the IRS prescription for addressing it, and examples provided by the IRS in proposed regulations are set out below.

Explanation of Provisions

A. Tax-Avoidance Arrangements Using Charitable Remainder Trusts

The IRS and the Treasury Department are aware of certain abusive transactions that attempt to use a section 664 charitable remainder trust to convert appreciated assets into cash while avoiding tax on the gain from the disposition of the assets. In these transactions, a taxpayer typically contributes highly appreciated assets to a charitable remainder trust having a relatively short term and relatively high payout rate. Rather than sell the assets to obtain cash to pay the annuity or unitrust amount to the beneficiary, the trustee borrows money, enters into a forward sale of the assets, or engages in some similar transaction. Because the borrowing, forward sale, or other similar transaction does not result in current income to the trust, the parties attempt to characterize the distribution of cash to the beneficiary as a tax-free return of corpus under section 664(b)(4). Distributions may continue to be funded in this manner for the duration of the trust term (which is usually short, so as to meet the 10-percent remainder requirement of section 664(d)(1)(D) or 664(d)(2)(D)). The appreciated assets may be sold and the transaction closed out (e.g., the loan is repaid) in the last year of the trust, or the trustee may distribute the appreciated assets, subject to a contractual obligation to complete the transaction (e.g., the forward sale contract), to the charitable beneficiary.

A mechanical and literal application of rules and regulations that would yield a result inconsistent with the purposes of the

charitable remainder trust provisions will not be respected. When section 664 was amended by the Revenue Reconciliation Act of 1997, Congress indicated that a scheme that, in effect, attempts to convert appreciated assets to a tax-free cash distribution to the non-charitable beneficiary is "abusive and is inconsistent with the purpose of the charitable remainder trust rules." S. Rep. No. 33, 105th Cong., 1st Sess. 201 (1997). Although the particular scheme that was the focus of Congress's attention in 1997 involved an attempt to exploit the interplay of rules under section 664 governing the timing of income and the character of trust distributions, the attempted result of the scheme (commonly referred to as an "accelerated charitable remainder trust") was the same as that claimed by the promoters of the transactions described above - that is, a literal application of rules governing trust distributions in an attempt to convert appreciated trust assets into tax-free cash in the hands of the non-charitable beneficiary. The latest schemes involving charitable remainder trusts are no less "abusive" or "inconsistent with the purpose of the charitable remainder trust rules" than were the accelerated charitable remainder trust schemes addressed by Congress in 1997.

B. The Proposed Regulations

Section 643(a)(7) authorizes the Secretary to prescribe regulations to carry out the purposes of the provisions of the Code relating to the taxation of estates, trusts, and beneficiaries including regulations to prevent avoidance of such purposes. The proposed regulations exercise this authority by modifying the treatment of certain distributions by charitable remainder trusts for purposes of section 664(b) to prevent a result that, as discussed above, is inconsistent with the purposes of the charitable remainder trust rules.

The proposed regulations provide that, to the extent that a distribution of the annuity or unitrust amount from a charitable remainder trust is not characterized in the hands of the recipient as income from the categories described in section 664(b)(1), (2), or (3) (determined without regard to the rules in these proposed regulations) and was made from an amount received by the trust that was neither a return of basis in any asset sold by the trust (determined without regard to the rules in these proposed regulations) nor attributable to a contribution of cash to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, the trust shall be treated as having sold, in the year for which the distribution is due, a pro rata portion of the trust assets. Any transaction that has the purpose or effect of circumventing this rule will be disregarded. For example, a return of basis in an asset sold by a charitable remainder trust does not include basis in an asset purchased by the charitable remainder trust form the proceeds of a borrowing secured by previously contributed assets.

The proposed regulations include examples that illustrate the application of the above rule. The IRS and the Treasury Department request comments on whether there are situations where the application of this rule would be inappropriate.

These proposed regulations adopt a pro-rata [sic] sale approach to determine the amount of gain on the distribution of funds acquired in advance of income recognition. The IRS and the Treasury Department also considered an approach that more directly related the distributed funds to the asset that is the subject of the borrowing or forward sale. Comments are requested on this alternative approach.

C. Proposed Effective Date

The regulations are proposed to apply to distributions made by charitable remainder trusts after October 18, 1999.

However, to the extent that a charitable remainder trust financed a distribution to a beneficiary by borrowing funds or entering into a forward sale or other similar transaction prior to the effective date of these regulations, the IRS may apply an appropriate legal doctrine to recast the entire transaction, to characterize the distribution as gross income rather than corpus, or to challenge the qualification of the trust under section 664. In appropriate circumstances, the IRS may impose the tax on self-dealing transactions under section 4941. Additionally, the trust may be treated as having unrelated business taxable income under section 512 from the transaction. The IRS will also apply any applicable penalties to the participants in the transaction.

Examples of how the new regulations would work are illustrated in the following three examples provided by the Internal Revenue Service:

Example 1. Deemed sale by trust. Donor contributes stock having a fair market value of $2 million to a charitable remainder unitrust with a unitrust amount of 50% of the net fair market value of the trust assets and a two-year term.

The stock has a total basis of $400,000. In Year 1, the trust receives dividend income of $20,000. As of the valuation date, the trust's assets have a net fair market value of $2,020,000 ($2 million in stock, plus $20,000 in cash). To obtain additional cash to pay the unitrust amount to the noncharitable beneficiary, the trustee borrows $990,000 against the value of the stock. The trust then distributes $1,010,000 to the beneficiary before the end of Year 1. Under section 664(b)(1), $20,000 of the distribution is characterized in the hands of the beneficiary as dividend income. The rest of the distribution, $990,000 is attributable to an amount received by the trust that did not represent either a return of basis in any asset sold by the trust (determined without regard to paragraph (b) of this section) or a cash contribution to the trust with respect to which a charitable deduction was

allowable. Under paragraph (b)(3) of this section, the stock is a trust asset because it was not purchased with the proceeds of the borrowing. Therefore, in Year 1, under paragraph (b)(1) of this section, the trust is treated as having sold $990,000 of stock and as having realized $792,000 of capital gain (the trust's basis in the shares deemed sold is $198,000). Thus, in the hands of the beneficiary, $792,000 of the distribution is characterized as capital gain under section 664(b)(2) and $198,000 is characterized as a tax-free return of corpus under section 664(b)(4).

Example 2. Adjustment to trust's basis in assets deemed sold. The facts are the same as in Example 1. During Year 2, the trust sells the stock for $2,100,000. The trustee uses a portion of the proceeds of the sale to repay the outstanding loan, plus accrued interest. Under paragraph (b)(2) of this section, the trust's basis in the stock is $1,192,000 ($400,000 plus the $792,000 of gain recognized in Year 1). Therefore, the trust recognizes capital gain (as described in section 664(b)(2)) in Year 2 of $908,000.

Example 3. Distribution of cash contributions. Upon the death of D, the proceeds of a life insurance policy on D's life are payable to T, a charitable remainder annuity trust. The terms of the trust provide that, for a period of three years commencing upon D's death, the trust shall pay an annuity amount equal to $x annually to A, the child of D. After the expiration of such three-year period, the remainder interest in the trust is to be transferred to charity Z. In Year 1, the trust receives payment of the life insurance proceeds and pays the appropriate pro rata portion of the $x annuity to A from the insurance proceeds. During Year 1, the trust has no income. Because the entire distribution is attributable to a cash contribution (the insurance proceeds) to the trust for which a charitable deduction was allowable under section 2055 with respect to the present value of the remainder interest passing to charity, the trust will not be treated as selling a pro rata portion of the trust assets under paragraph (b)(1) of this section. Thus, the distribution is characterized in A's hands as a tax-free return of corpus under section 664(b)(4).

IRS Issues Letter Ruling Approving New Technique For Gifting Debt-Encumbered Property to Charities and Charitable Remainder Trusts

Subject to certain exceptions, transferring debt-encumbered real estate to charity can produce a number of undesirable consequences. First, the donor can realize income from a constructive bargain sale since the amount of debt involved will be treated as the purchase price in a bargain sale transaction. Secondly, debt-encumbered property typically results in "acquisition indebtedness" which in turn can result in unrelated debt-financed income which in turn is treated as unrelated business taxable income to the charity.

With regard to charitable remainder trusts, all of these problems were historically present, but beginning with LR 9015049 issued in 1990, a new obstacle was erected for charitable remainder trusts. Specifically, under the rationale of that ruling, in addition to the general problems applicable to all charitable entities described above, transferring real estate subject to recourse indebtedness to a charitable remainder trust creates a grantor trust which, under the regulations governing Section 664, means that a valid charitable remainder trust has not been created.

These obstacles to gifts of debt-encumbered property have dramatically reduced these gifts in general, and have almost eliminated these gifts to charitable remainder trusts in particular. Now, a new for-profit company, Thornburg Foundation Realty, has utilized a common real estate investment technique to help charities and their prospective donors get around these obstacles. The technique is an umbrella partnership real estate investment trust ("UPREIT"). All of this is very complicated, and will accordingly be discussed in much greater detail in the Planners' Forum in the next issue of CGPN. However, the basic structure of a TFR transaction would find an individual with debt-encumbered property transferring that debt-encumbered property to the umbrella partnership (which is a limited partnership) that has as its general partner the corporate entity that constitutes the real estate investment trust. Then, the individual would receive in return for the transfer units in the limited partnership equal to the equity value of the property transferred. These units would be exchangeable on a one-for-one basis for shares in the REIT.

Then, the individual would typically transfer some or all of the units to charity or to a charitable remainder trust which would then be expected, at some point, to exchange the units for shares in the REIT.

One of the key features of the TFR technique is the complete payment of all debt by the REIT soon as the property is transferred to the limited partnership.

All of this allows an individual to transfer real estate to an investment vehicle with little or no gain recognition and receive units in a limited partnership. Then, if and when the investor decides to become a donor and transfer the units to charity, he will enable the charity to become a shareholder in a taxable corporation, the REIT, which Thornburg Foundation Realty anticipates taking public within a year to 18 months.

While this technique is new, this letter ruling issued to one of the first prospective donor/investors in Thornburg Foundation Realty is a very promising beginning to what may be a solution to the "debt problem" associated with gifts of debt-encumbered

real estate to charity. TFR also addresses other drawbacks to a charity's holding property such as management obligations, carrying costs and hazardous waste issues. As promised, more details will follow in the next issue of CGPNews.

Lease Income for Rental of Real Estate is Tax Exempt Income to Charity

LR 199940034. This ruling serves as a basic primer on the rules relating to when lease income is (and is not) tax-exempt when received by a charity.

In this instance, a fraternal lodge exempt from income tax under Section 501(c)(10) controls a charitable organization described in Section 170(b)(1)(A)(vi) which provides testing for learning disabilities in children and conducts classes for teachers and parents about learning disabilities.

The lodge proposes to transfer unimproved real estate and an undisclosed amount of cash to the charity to partially cover the cost of the erection of a building which will be used, in part, by the charity in carrying out its exempt purposes.

The building will be built in two phases. The first phase will result in space which will be used two-thirds by the charity and one-third by the lodge for its office facilities. The second phase will be used by the lodge for its fraternal activities, and would also provide substantial additional space which will be sublet by the lodge to other entities, including for-profit entities. The space will also be made available on a fee basis for weddings and other events.

The land and building will be owned exclusively by the charity. The lodge will pay a market value lease amount for the office facilities in phase one and for the entire facility composing phase two. The amount of rent to be charged will be determined by an independent real estate appraisal.

While the funds transferred by the lodge to charity will not cover the complete cost of construction of the building, it is anticipated that the remaining funds necessary to build both phases of the structure will be raised from the public. It is not anticipated that the charity will incur any debt in constructing the building.

The question is, will be lease income received by the charity produce taxable income to the charity? In this ruling, the IRS rules that it will not. Specifically, Section 512(b)(3) excludes all rents from real property from unrelated business taxable income.

Under the unrelated business taxable income rules of Section 512 and unrelated debt-financed income rules of Section 514, charities may encumber property to erect facilities to carry out the charity's exempt purpose without producing "acquisition indebtedness" which produces unrelated debt-financed income and, therefore, unrelated business taxable income. However, construction of a building utilizing borrowed funds, in whole or in part, where the building will be leased for the purpose of producing income for the charity will produce acquisition indebtedness, unrelated debt-financed income and unrelated business taxable income. Here, no debt is anticipated. Consequently, no adverse consequences of this nature will result for the charity.

In summary, because the building will be owned debt-free by the charity and utilized by the charity for its exempt purposes, or alternatively will be rented at fair market value to other entities, and furthermore, since the charity will provide no services to the tenants other than those usually and customarily rendered in connection with the rental of real estate space for occupancy only [another requirement under Section 512(b)(5), Section 513(a) and Treas. Reg. Section 1.513-1(a)], no unrelated business taxable income will result from the arrangement.

Charities are obviously constantly erecting buildings, and they are constantly borrowing money to do so. However, it is important to remember that charities can only borrow money to build buildings that it will use in furtherance of its exempt purposes if it wishes to avoid unrelated business taxable income. Borrowing money to build buildings which will be rented for the production of income will make otherwise tax-free rent taxable as unrelated business income. Here, the charity has its "house in order," and it will have a facility that will enable it to carry out its exempt purposes and additional space, the rent from which will provide additional financial support to enable the charity to carry out its exempt purposes.

Some People Don't Know When to Leave Well Enough Alone

TAM-102743-99. An individual created a revocable trust that established a marital deduction trust for his spouse at his death, paid his debts, taxes and expenses, made a specific pecuniary bequest and provided for the creation of charitable remainder unitrust with the remainder of the original revocable trust principal and any unpaid income of the original revocable trust. Subsequent to the date that the trust was executed, the decedent amended the trust eight times. In the process, he managed to delete all of the qualifying unitrust language and at his death, the residuary gift merely provided for the net income from the residuary of the trust to be paid to named individuals for life with the remainder passing to charity.

The decedent's estate filed an estate tax return and claimed a charitable deduction for the value of the remainder interest in trust.

The trust, as last amended, did not constitute a qualifying charitable remainder unitrust under Section 2055(e)(2). In 1984, Congress enacted Section 2055(e)(3) which provides for qualified reformations of defective trusts. Where there is an intent to comply, i.e., the payment to the noncharitable beneficiary is a stated dollar amount per annum or is a fixed percentage of the trust assets (i.e., a unitrust amount), the trust may be reformed at any time. However, where the income payment to the noncharitable beneficiary does not take one of these two qualifying forms, but provides, as here, for payment of merely the net income to the noncharitable beneficiaries, a "no intention to comply" trust is created. In such an event, a qualified reformation must be instituted within 90 days after the due date (including extensions) of the estate tax return or, in the case of a lifetime trust, within 90 days after the due date (including extensions) of the trust income tax return. In this instance, the donor started out with a qualified charitable remainder trust, but progressed to the point of finally leaving a trust which did not even evidence an intent to comply. Consequently, since no reformation proceeding was instituted within the time provided by the statute, the estate tax charitable deduction for this charitable trust was lost.

Bankruptcy Sale Price Does Not Establish Value

Herman v. United States, Docket No. 2:99-CV-290 and Brown v. United States Docket No 2:99-CV-119, U.S. District Court for the Eastern District of Tennessee (9/28/99). When the Johnson County Memorial Hospital filed a voluntary petition under Chapter 11 of the Bankruptcy Code, the Hermans and the Browns set out to reopen the hospital for the benefit of the community. Hearing that the hospital planned to auction off all of its equipment in an effort to raise $37,000, they approached the bankruptcy court and offered to buy the equipment for $40,000. The offer was accepted, and they acquired the property in October 1988. In December 1990 they donated this equipment to a limited liability company formed to create the new hospital. Their accountant suggested that they have the equipment appraised so that they could claim a charitable deduction, and two separate medical equipment companies estimated the value of property at just over $1,000,000. The Browns and the Hermans each claimed a deduction of approximately $500,000. On audit, the Internal Revenue Service allowed the deduction only to the extent of the donors' $40,000 cost basis in the property, and imposed penalties for what it viewed as a "gross valuation misstatement."

The District Court held for the donors, finding that the fair market value of the equipment was approximately $1,000,000, as reported on their returns. The court rejected the IRS contention that the bankruptcy court was a willing selling seller under no compulsion to sell. Since the bankruptcy sale was made in haste, without objection from creditors and without a valuation hearing, the price paid under these circumstances was found not to be determinative of value. Rather, the court concluded it was justified in relying upon a qualified appraisal made by a qualified appraiser. The court found that there was no fault on the part of the taxpayers, who apparently recognized that potentially valuable hospital equipment was about to be sold at a low price and lost to the hospital they hoped to create. They were not capitalizing on the distress sale price to sell the equipment at a profit, but were merely acting to keep it in place for their new hospital. While these apparently altruistic efforts produced an income tax windfall for the donors, the court found they had acted with no intent to defraud and were entitled to this benefit.

Manufacturers' Coupons Produce Deductions

LR 199939021. A Company is creating a program whereby it will issue manufacturers' coupons redeemable at local stores upon the purchase of certain items. Participants in the program will receive cards and, when a person applies for a card, he or she must designate whether they want the face value of the manufacturers' coupons to be redeemed for cash at the store or whether all or a portion of the rebate will be collected by the Company and paid over to a charity. This designation can be changed at any time upon written notice to the Company.

In this ruling, Internal Revenue Service held that a cardholder who designates 100 percent of her coupon discounts to be paid to charity is entitled to a charitable contribution deduction for the rebates paid to charity on her behalf. The payments in question are voluntary, since the cardholder has the opportunity to receive her rebates at the point of sale. Thus, this situation is distinguishable from the group insurance program in the leading Supreme Court case of United States v. American Bar Endowment, 477 U.S. 105 (1986). There, the Court upheld denial of a deduction for a refund paid to charity where the purchaser was found to have no choice as to whether the amounts in question would be paid to charity.

Of course, the usual rules governing substantiation are applicable, and in this situation the Company will supply the donee charity with the amount of each participant's rebates, thus enabling the charity to provide the required substantiation.

Self-Dealing Briefs

A number of recent rulings have found various types of transactions and arrangements to be beyond the scope of the self-dealing rules. Here are a few, in summary fashion:

LR 199943053. A private foundation will create an adult foster home with room for only six individuals. One of the prospective residents will be a disqualified person (who has been tested by the county and meets the criteria for residence). HELD: This is

OK, since the foundation is permitted (under Code Sec. 4941(d)2)(D)) to make services and facilities available to a disqualified person on a basis no more favorable than that on which it deals with the general public.

LR 199939046. Several foundations may form an investment partnership in order to pool their resources and make investments that would otherwise be unavailable to them. The investment partnership itself will not be a"business enterprise" for purposes of the excess business holdings restriction, even if its income is not primarily passive.

LR 199943047. A person who was formerly a director of a private foundation, but resigned from the board in order to bid upon business assets to be sold by the foundation, is no longer a disqualified person and may bid for and purchase assets from the foundation without violating the self-dealing rules.

LR 199939049. Husband and wife, directors of a family foundation, plan to withdraw two parcels of land from a family limited liability company (LLC) operating a farm and orchard, and contribute them to the foundation for use as the location of an educational institute. The Institute will bear a name similar to that of LLC, and will focus upon agricultural and farm issues. Although Husband, wife and LLC are all disqualified persons, the self-dealing rules do not affect this gift or the operations of the Institute, since no goods or services or preferential treatment will be given to them. The name of the Institute and its proximity to the family farm were found to result in no more than an incidental and tenuous benefit.

LR 199941053 . A private foundation is entitled to receive half of the residue of a decedent's trust, including certain real property which may have environmental liability problems, with the balance passing to the decedent's nephews. The foundation and the nephews may enter into an indemnification agreement with the sole trustee of the foundation to indemnify him against potential liability for environmental damages imposed under State law.

Pull Tab Revenues Produce UBIT Deduction

Technical Advice Memo 199941043. A charitable organization conducts pull-tab games in accordance with Washington State law, which requires that all gambling revenues be devoted exclusively to exempt purposes. Gambling proceeds are kept in a separate account and eventually transferred to the organization's general account. The organization reported its pull-tab revenue as unrelated business income, but later filed amended returns claiming business expense deductions when the revenues were transferred to the organization's account and spent for its exempt purposes.

The Internal Revenue Service agreed with the organization, noting that the state law requiring the funds to be spent in a particular manner in order to maintain the organization's gambling license rendered these payments "ordinary and necessary," and hence deductible as business expenses. However, such deductions would not be allowable until the actual expenditures were made, and not when the funds were merely transferred between accounts.

Foundations Seek International Grant Guidance

In a letter from its General Counsel, John A. Edie, the Council on Foundations has requested guidance for private foundations making international grants. Increasingly, U.S. foundations are making grants abroad to support the creation of democratic institutions and free market economies, as well as for more conventional health, welfare and educational purposes. The current rules require foundations to satisfy difficult administrative requirements for grants to foreign charities. The foundations must either make an "equivalency determination," presenting difficult questions of foreign law, custom and accounting practices, or apply the often-difficult rules governing grants to other private foundations. Mr. Edie pointed out that it is simpler for private foundation to make grants to foreign non-charitable organizations than to foreign charities.

To remedy the situation, the Council on Foundations suggested that the Treasury Department and IRS implement a three-part program:

(1) Simplification of the affidavit procedure for foreign charities receiving substantial support from a foreign government;

(2) Creation of a presumption for purposes of the U.S. private foundation rules that a foreign organization receiving substantially all of its support from foreign sources is NOT described in section 501(c)(3), so that the "expenditure responsibility" rules would apply; and

(3) Clarification that three years of expenditure responsibility will suffice for endowment or capital equipment grants.

In addition, it was suggested that the rules be clarified to indicate just how much "reasonable effort" is required for compliance in

situations where a foreign grantee does not cooperate in providing necessary reports.

These changes would require amendments to the regulations under section 4945 and/or other official announcements. Watch for future developments!

Thornburg Foundation Realty and Gifts of Real Estate to Charity

Editor's Note: In Charitable Gift Planning News, your editors attempt to provide you, our readers, with an objective and usable description of news in the planned giving world. In the Planners' Forum column, we provide commentary and planning opportunities that allow for a bit more subjectivity. On occasion, one of your editors is at the center of a news-making event, and this presents the opportunity to provide a uniquely in-depth analysis of the event. Such is the case with the recent private letter ruling which the IRS has issued (but not yet released to the public) involving the Thornburg Foundation Realty UPREIT. This ruling was recently the subject of a 10-page analysis by the Planned Giving Design Center as well as news articles in publications ranging from CASE Currents to the Wall Street Journal. This potentially landmark development in the area of gift planning was reported in the news section of last month's CGPN, and it is the subject of this month's extended Planners' Forum. Because Terry Simmons was the lead attorney in obtaining the private letter ruling, he tells the story of the ruling and the context in which it was obtained in the first person. The conclusions he reaches are consistent with those reached by other commentators, but with the concept having caught the attention of the broader media and with numerous articles on the way, his analysis gives a "you were there" perspective on what may prove to be one of the more significant new planning concepts in years. We hope you find the column informative and useful.

Introduction

When I first met Garrett Thornburg and Jay Grab some 18 months ago, I was skeptical, to say the least, of their new company, American Foundation Realty (now known as Thornburg Foundation Realty). Having been a point man in the charitable community's dealings with some for-profit entities intent upon making a fast buck in the charitable world through abuse of the charitable deduction provisions of the Code and through even more questionable ethics, I was many-times burned and several-times shy. However, after our initial meeting and the many meetings which followed it, and after researching Jay's and Garrett's professional backgrounds in-depth, I became convinced that their motives were straightforward, their program was sound and collectively we had an opportunity to take a giant step toward solving one of the last major impediments to charitable giving: helping charities access the vast stores of real estate wealth that, for numerous reasons, have until now escaped the reach of philanthropy. However, having a good program and having that program be well-received by the charitable community are entirely different matters. In addition to a massive educational effort within the charitable community and the community of advisors to charities, it would be necessary to obtain a private letter ruling from the IRS on behalf of a prospective donor through Thornburg Foundation Realty to lay a predicate for the success of the new endeavor.

Believing that the program was good for philanthropy, I joined the team and began to work with the Thornburg Foundation Realty staff in bringing the plan to fruition. The primary task was obtaining the private letter ruling, and that process along with the analysis of the ruling received is discussed at length below. However, before we discuss the letter ruling, a review of the issues that made the ruling (and Thornburg Foundation Realty) necessary is in order.

Tax Issues at Hand

I.R.C. Sec. 514 defines "acquisition indebtedness" generally as indebtedness related to the acquisition or improvement of property, including real property. With the presence of acquisition indebtedness comes potential unrelated debt-financed income which, in turn, produces unrelated business taxable income. The tax can drain the resources of the charity, and if the activity is pervasive, the charity can lose its exempt status.

In general, property subject to acquisition indebtedness will have a portion of its income taxed as unrelated debt-financed income. Additionally, when a person transfers appreciated property subject to indebtedness to a charity, a deemed "bargain sale" occurs so that the donor's basis in the property is allocated pro rata between the gift element and the sale element of the transaction. The result of this allocation is the recognition of a portion of the capital gain inherent in the property upon the transfer of the property to charity.

Sec. 514 of the Code provides some measure of relief in certain circumstances. If a donor has owned the property in question for at least 5 years, and if the indebtedness against the property has been in existence for at least 5 years, then the property will not be deemed to be held subject to acquisition indebtedness for a period of 10 years after its transfer to charity. This postpones the unrelated debt-financed income problem, but it has no effect on the potential "bargain sale" consequences.

The problems for gifts described above are present with gifts to charitable remainder trusts as well. However, the problem is aggravated by the provisions of I.R.C. Sec. 664 which give exempt status to a charitable remainder unitrust or charitable

remainder annuity trust except for years in which unrelated business taxable income is present. In those years, the tax exempt status of the trust will be lost. Furthermore, a sale of property in a charitable remainder trust subject to acquisition indebtedness will be taxed even if the sale occurs after the acquisition indebtedness is satisfied (but within 12 months). Historically, then, the "five and five rule" became critical to transactions involving the transfer of debt-encumbered property to charitable remainder trusts. The 10-year grace period available upon a transfer of property meeting the criteria described above literally was essential to allowing charitable remainder trusts to take these gifts. If the grace period was available, gifts of debt-encumbered property could be made to charitable remainder trusts with the "bargain sale" element being the only adverse effect. At least, this was the case until 1990.

In that year, LR9015049 was released. After years of issuing favorable rulings on transfers of debt-encumbered property to charitable remainder trusts, the IRS abruptly reversed course. In that ruling, the IRS espoused the position that a charitable reminder trust established by transfer of property subject to recourse indebtedness created no valid charitable remainder trust at all. Specifically, Treas. Reg. Sec. 1.664-1(a)(4) provides that a charitable remainder trust "must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust." The regulation goes on to add that "the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust" under the grantor trust rules. Under the income tax grantor trust rules, where an individual transfers debt-encumbered property to a trust and remains liable for the debt, the individual is deemed to be the owner of the trust. Consequently, the interaction of these provisions, according to the IRS in the 1990 ruling, meant that debt-encumbered property could not validly fund a charitable remainder trust unless the lender had no recourse against the donor after the transfer in trust. That was seldom the case.

After the ruling, gifts of debt-encumbered property to charitable remainder trusts dropped dramatically. For a decade, only the most creative and aggressive of charities were able to receive gifts in trust out of this property category.

As this problem was discussed and rediscussed by members of the planned giving community in the years that followed the 1990 ruling, it seemed that only legislation could resolve this impediment to giving encumbered property to a charitable remainder trust. For the past 10 years, the working agenda in the charitable community, legislatively speaking, included reversal of the outcome in LR 9015049. However, it became clear that explaining the intricacies of LR 9015049 to staff and members and creating comprehension and a sense of urgency among the tax committees on this issue was proving to be a daunting task. Consequently, a major source of support for American philanthropy quickly evaporated. Furthermore, beyond the tax issues, the general illiquidity of real estate, its intrinsic management-intensive nature, the potential liability for charities owning real estate, and the potentially devastating liability for owning real estate contaminated with hazardous waste compounded the problem.

The Beginning of an Answer

Three years ago Jay Grab was the President of an extremely successful real estate investment and management firm. He was in Dallas doing what he did best: acquiring real estate, in this case from a large tax-exempt organization. In the midst of the closing, he heard the charity turn down a gift of real estate. Jay had been involved enough with charities over the years (his wife, Rachel, founded the Shakespeare Festival in Santa Fe) to be shocked at the prospect of a charity turning down a gift, particularly within an asset category that he thrived upon in his own personal business. He began to ask questions and the outline of the problems described above began to emerge. He determined to solve the problem, and took a one-year leave of absence from the presidency of his company. He approached Garrett Thornburg, a fellow Santa Fe resident and the principal in the $2.5 billion Thornburg Funds, a family of mutual funds, and the $4.5 billion Thornburg Mortgage Asset Corp., a mortgage real estate investment trust (REIT), about collaboration in his efforts. Garrett agreed, and the process began to move.

Soon, it became clear that if the problems created by LR 9015049 were successfully addressed, all of the other problems would essentially be solved in the process. Thornburg and Grab soon settled upon the potential vehicle for deliverance: an umbrella partnership real estate investment trust (UPREIT). An UPREIT is a business form comprising a limited partnership (the umbrella partnership) with a corporate general partner that also is a REIT. Under the program as envisioned, individuals with real estate that potentially might be given to charity would transfer the real estate to the UPREIT for units in the limited partnership equal to the value of the real estate transferred. This would generally occur on a tax-free basis. However, since most transfers of the property to the UPREIT would be transfers of debt-encumbered property, the transferor would instead receive units in the partnership equal to the transferor's equity in the property. To facilitate subsequent anticipated gifts of units to charity, the partnership would immediately pay off all debt associated with the property transferred. The general partner would provide the cash to pay off the debt through the utilization of a graduated line of credit up to $80,000,000 and would in turn receive units in the partnership equal to the amount of the payoff in each instance.

While this went far towards solving the debt problem regarding real estate gifts, we were not completely there. While the payoff of debt often would occur simultaneously with the transfer, in some instances a period of days might pass before the payoff simply because of the paperwork and documentation involved. Furthermore, it was less than certain that even a simultaneous payoff of the debt would satisfy the acquisition indebtedness problem. Accordingly, a mechanism to provide absolute safety on

this issue was critical. It was then that a semi-monthly interim-closing-of-the-books method of accounting become a key ingredient of the program.

I.R.C. Sec. 706(d)(1) provides that, with respect to a partner whose percentage interest in the partnership varies during any taxable year of the partnership, each partner's distributive share of various items of income and loss for the taxable year shall be determined by the use of any method set forth in the regulations that takes into account the varying interests of the partners. With respect to gifts of partnership interests under Sec. 706(c), Treas. Reg. Sec. 1.706-1(c)(4) provides only that the partnership taxable year does not close with respect to such a donor and that the income of the partnership prior to the date of the gift should be allocated to the donor.

The legislative history of Sec. 706(d)(1), which was added to the Internal Revenue Code in 1984, indicates that a partnership whose partners have varying interests during the year may choose between an "interim-closing-of-the-books" method or a pro rata method to allocate partnership income in this situation. Under the "interim-closing-of-the-books" method, the distributive share of a partner who becomes a partner or leaves the partnership during the year is computed exactly by closing the partnership books on the date the partnership year begins with respect to a new partner, or ends with respect to a selling or retiring partner.

Moreover, while no regulations have yet been issued with respect to Sec. 706(d), the IRS issued News Release 84-129 in 1984, which provided that a partnership using the "interim-closing-of-the-books" method to make allocations to partners with varying interests would be permitted to use a semi-monthly convention with respect to closing the books until further regulations are issued under Sec. 706. (At this point, it is rather doubtful that any such regulations will ever be issued.) Under the semi-monthly convention, partners who enter a partnership during the first 15 days of a month are generally treated as entering on the first day of the month and the partners who enter after the 15th day are treated as entering on the 16th day of the month.

In the Thornburg UPREIT, it was resolved that the partnership would operate on a debt-free basis through the use of an interim-closing-of-the-books method with the semi-monthly convention. Contributions of debt-encumbered property will occur during the first half of each month, and subsequent charitable donations of partnership units will always be made during the second half of a month. This follows because contributions of debt-encumbered property to the UPREIT will occur only during the first half of a month, and the debt with respect to such property will be paid off during that same 15-day period. The books will then close on the 15th, and for the remainder of the month no additional transfers of property, or at least of debt-encumbered property, will be accepted. The UPREIT will otherwise operate so as to produce no unrelated business taxable income. Consequently, the transfer of units to charity or to a charitable remainder trust during the second half of the month will be a transfer of property totally free of acquisition indebtedness and totally free of unrelated business taxable income.

Under the terms of the UPREIT, a unit in the partnership may be exchanged for a share of stock in the corporate general partner REIT at any time. This one-for-one exchange ratio will be a permanent feature of the UPREIT. While the transfer of real estate to the UPREIT in return for units in the partnership should generally be a tax-free transaction for the transferor, except to the extent that the debt in existence exceeds the transferor's basis in the property, the exchange of units for shares would constitute a recognition transaction with regard to any remaining inherent long-term capital gain. While transferors to the UPREIT may choose to hold the units as an investment or may choose to allocate units among charities, charitable remainder trusts, or family members, it is nonetheless contemplated that any units destined for charity will have the advantage of a tax-free exchange of units owned by the charity or charitable trust for shares in the REIT.

The Letter Ruling

As previously indicated, it was clear that Thornburg Foundation Realty (TFR), to succeed, would have to be exposed to IRS scrutiny at the outset. The appropriate technique for doing this (in fact the only practical technique for doing this) was to obtain a private letter ruling on a proposed transaction**.**

The transaction that presented itself involved an individual who owned a limited liability company which in turn owned commercial real estate of an approximate value of $1,000,000 with debt against the property of $325,000. The LLC had a tax basis in the real property of $275,000. The property was long-term capital gain property in the hands of the LLC. The LLC desired to create a term-of-years charitable remainder unitrust to run for a period of 20 years with the unitrust amount being payable to the LLC. The trust would be a "flip" unitrust, with the flip event being the date upon which all of the partnership units held by the trust were converted to marketable securities. Until that time, the trust would function as a net income charitable remainder unitrust.

Throughout the planning process, we worked closely with the California law firm of Jeffers, Shaff & Falk LLP, a firm with substantial expertise in REIT law that had represented the Thornburg interests for decades. Together, on behalf of the LLC, we began to formulate a ruling request. Seven questions were posed to the IRS for rulings. Specifically, we asked the IRS to rule:

1. The Company (LLC) would be a permissible grantor of the trust.

2. The trust would qualify as a charitable remainder trust described under Sec. 664(d)(2) and Sec. 664(d)(3) of the Internal Revenue Code.

3. The satisfaction of the debt by the operating partnership or its general partner during a semi-monthly period for allocating partners' varying shares in partnership items in which the trust does not hold any partnership units would prevent the trust from holding the partnership units subject to acquisition indebtedness under Sec. 514 of the Code.

4. The conversion of partnership units to shares of common stock in the REIT would not result in UBTI to the trust, and the conversion would therefore not generate a tax liability to the trust or adversely affect the trust's federal income tax exemption.

5. Based on the facts submitted, the trust would not recognize UBTI from activities of the operating partnership.

6. The gift of partnership units to the trust and the subsequent exchange of the partnership units for common stock of the REIT should not be recharacterized for federal income tax purposes as the conversion of partnership units into REIT stock by the Company followed by the subsequent contribution of the REIT stock to the trust by the Company.

7. Neither the ownership nor sale of shares of common stock in the REIT will result in any UBTI to the trust.

As anyone who is involved with securing letter rulings on a regular basis is aware, this is a tricky business. Often, the issues that you think may present the most problems for the IRS will be resolved swiftly, while seemingly straightforward issues may occupy the IRS for weeks or even months. Such was the case here. The "interim-closing-of-the-books" method was well established in tax law, but was novel in application to charitable transactions. This is where we anticipated the most difficulty. The actual reaction of the IRS, surprisingly, was otherwise. After 10 months of working with three divisions of the IRS: Employee Benefits and Exempt Organizations, Branch 3 of Passthroughs and Special Industries, and Income Tax and Accounting, a ruling was successfully obtained. In regard to the seven ruling requests, the IRS ruled as follows:

1. The IRS summarily agreed that an LLC was an appropriate grantor and beneficiary of a charitable remainder unitrust.

2. The IRS ruled that the trust would qualify as a charitable remainder trust under the Code and, as such, would generally be exempt from tax. This ruling meant that the trust, as proposed, with its 20-year term and its "flip" provisions meets the requirements of recently published regulations under the Code to qualify as a flip unitrust. (Since no model form exists for a term-of-years trust or a flip unitrust, the IRS was free to rule on the qualification of the trust in this instance).

3. The trust will not recognize UBTI from any debt-encumbered property transferred to the operating partnership if it does not hold the partnership units in any semi-monthly period when such properties are transferred to the operating partnership. The IRS approved the operating partnership's semi-monthly "interim-closing-of-the-books" method for allocating the debt financed income between segments of the month. Therefore, the ruling provides clear guidance that the trust, and presumably other charities holding a limited partnership interest, would not have UBTI if the partnership had received any property subject to debt that was paid off inthe first-half of the same month that the trust or charity received its operating partnership units.

4. The exchange of partnership units for the common stock of the REIT will not result in UBTI for the trust. Therefore, the conversion of partnership units to stock (and the subsequent sale of the stock) by a charitable remainder trust or charity will not adversely affect the federal tax exemption of the trust or the charity.

5. The IRS concluded that the trust, when holding limited partnership units, will not recognize UBTI from the proposed operational activities (as opposed to passive debt-financed income) of the operating partnership. This means that the proposed method of administering the operating partnership will not generate UBTI for a charitable remainder trust or charity.

6. With regard to the requested ruling that the transaction would not be recast as an exchange of units

by the Company for shares in the REIT followed by a contribution of the shares to the unitrust (a recharacterization that would result in the triggering of all inherent capital gain and taxation of that gain to the transferor), the IRS deferred. The IRS stated that the determination of whether the transaction should be recharacterized depends on all the facts surrounding the transfer and can only be decided on examination by the District Director's Office of the Federal income tax returns of the parties involved. The IRS cited Palmer v. Commissioner, 62 T.C. 684 (1974), Blake v. Commissioner, 697 F.2d 473(2d Cir. 1982), Rev. Rul. 78-197, 1978-1 C.B. 83, and Notice 99-36, 1999-26 I.R.B. 3. (We will discuss this in further detail below.)

7. Ownership and sale of common stock of the REIT will not result in UBTI to the trust. This means that when a charitable remainder trust or charity which owns or sells REIT common stock receives dividends or sales proceeds from a sale of the stock, those amounts will not be deemed UBTI for the charitable remainder trust or charity.

Ruling Request #6: The Palmer Issue

What did the IRS mean in the language employed in its response to Ruling Request #6? First, a little history. As has often been discussed in this space, the Palmer case involved a transfer of closely held stock to charity followed 24 hours later by a redemption of that stock by the corporation. The donor received nothing of value in the transfer, but the donor controlled both the corporation and the charity. While clearly the transfer and redemption was anticipated by all the parties, the Palmer court held that no prearranged transaction or assignment of income was present. In 1978, in Rev. Rul. 78-197, the IRS acquiesced in Palmer, stating that "the Service will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption."

After Rev. Rul. 78-197 came the Blake case. In Blake, quintessentially bad facts made quintessentially bad law. Mr. Blake owned a ship that was later valued and sold at $250,000. Mr. Blake donated $687,875 of publicly-traded stock in his company to a charity with the understanding (the Court found it to be an obligation of the charity) that the charity would use $675,000 of the proceeds of the sale of the stock to acquire the ship from him. The Blake court recharacterized the transaction as a sale of the securities (a transaction taxable to Blake) followed by a contribution of the ship to the charity. The court found the necessary obligation was present, and that if it wasn't, it was close enough that no further obligation was necessary!

In subsequent letter rulings, the IRS has clearly distinguished Palmer from Blake and indicated that Rev. Rul. 78-197 continues in effect.

Then came the much criticized charitable reverse split-dollar life insurance plan. That concept has been much discussed in these pages, but fundamentally, an individual transfers cash or securities to a charity with the understanding that the charity would use the donated assets to pay the premiums on an insurance policy on the donor's life with the benefits of the insurance being divided between the charity and the individual's family. The process was deemed so abusive that Congress introduced legislation over a year ago to kill the practice, and Congress prodded the IRS into action as well, primarily for the purpose of establishing that the concept does not work even under existing law. Consequently, the IRS issued Notice 99-36 - a broad-based attack on charitable reverse split-dollar life insurance. While appreciated property was not involved, the IRS cited Blake as authority for its ability to recast the transaction in the presence of abuse so as to reflect the true realities of the transaction. After referring to Blake (and not to Palmer or Rev. Rul. 78-197), the IRS stated in Notice 99-36 that "similarly, in a charitable split-dollar insurance transaction, the Service will apply the substance-over-form doctrine based on the mutual understanding between the taxpayer, the insurance trust (or other related intermediary), and the charity. The Service will treat the transaction as one in which the taxpayer obtains an insurance policy, pays premiums with respect to that policy, and transfers some of the rights under that policy to the trust and the remaining rights to the charity." This analysis allowed the Service to find that the split-dollar arrangement failed the partial interest requirements of Code Sec. 170(f)(3)(B)(ii).

Timing is everything. Given that the author of Notice 99-36 was the author of the IRS response to Ruling Request #6, and given that Notice 99-36 and the TFR ruling were issued almost simultaneously by the IRS with the ruling trailing slightly behind the Notice, the response to Ruling Request #6 is in fact rather good news. The IRS had been continuously pressed by Congress, the charitable community and press accounts into doing something about the "scandal of charitable reverse split-dollar life insurance." In Notice 99-36, the IRS did so in a barrage utilizing almost all of the relevant artillery in the IRS arsenal. This included a rather strained application of Blake. Notice 99-36 did not involve an assignment of income under the prearranged transaction doctrine. Rather, it involved what was viewed as an abusive transaction involving the transfer of property to charity with the obligation (or at least the strong understanding) that the charity would in turn provide a return benefit to the donor or the donor's family in the form of the payment of the insurance premiums on the donor's life, the benefits of which were commonly shared. This is the distinctive nature of Blake and Notice 99-36: a transfer occurs to charity with the obligation or the understanding that a benefit will be received by the donor or the donor's family from the charity in return. Palmer and Rev. Rul. 78-197, on the other hand, involve no transfer in return for a benefit, except for the obvious charitable deduction. The response

to Ruling Request #6, given the context of what was going on with Notice 99-36, can be paraphrased as follows:

> We [the IRS] have just used Blake to kill an abusive transaction. We see nothing about the TFR transaction that is abusive, and if it proceeds as represented, there will be no recharacterization upon audit. But we have had a lot of trouble with abusive transactions, and if sleight-of-hand is involved here, and if the facts do not turn out to be the same as the facts represented, then we will not hesitate to recharacterize the transaction. Hence, we are citing Palmer and Rev. Rul. 78-197 with its statement that recharacterization will not occur unless the charity or charitable remainder trust is legally bound, or can be compelled by the REIT, to surrender the shares for redemption. On the other hand, if the facts ultimately reveal that this is an abusive transaction, we are also citing Blake and Notice 99-36, and we will not hesitate to use them to stop the abuse.

Quite simply, the IRS had just used Blake to kill an abusive "giving" technique. After a full review of the TFR transaction, no abuse was found or inferred, but the Income Tax and Accounting Division of the Office of Chief Counsel is keeping its options open. During the ruling process, it was made clear that this is the kind of ruling one can expect in a situation involving gifts by individuals of non-stock assets followed by redemption, as opposed to gifts of closely held followed by corporate redemption (classic Palmer). While a clean Palmer ruling can still be anticipated in a transaction where closely held stock is transferred and redeemed (since that ruling would come from the Corporate Income Tax Division of the National Office of the IRS) a transfer of other assets by an individual followed by redemption is likely to produce a more open-ended answer since that answer will come from Income Tax and Accounting.

The Two-Year Rule

In the factual recitation of the letter ruling, the IRS notes that the partnership agreement requires that a transferor of property to the UPREIT in return for units agree to hold those units for two years before converting those units to shares in the REIT. A charity or charitable trust who is a transferee of the units may tack the holding period of the transferor in meeting the two-year requirement period. Consequently, in this ruling request, the LLC noted that it would hold the units for two years before transferring them to the charitable remainder unitrust, whereupon it is anticipated (but not required!) that the units would be exchanged by the charitable remainder unitrust for shares in the REIT. Why is this two-year rule present? In 1994, the Internal Revenue Service acted on a long-standing perception of potential abuse in the area of partnership taxation. It promulgated Treas. Reg. Sec. 1.701-2 which gives a number of examples of partnerships that are within a regulatory "safe harbor" and those that are clearly abusive. One of the safe-harbor examples, Example 4, illustrates an UPREIT. In the example, a two-year prohibition on exchange of units for shares such as the one described above is included in the factual recitation. The partnership abuse regulations have been heavily criticized by the tax community (see "Partnership Anti-Abuse Regs. Revisited: Is There Calm After the Storm?" by Richard M. Lipton, edited by John S. Pennell, J.D., and Samuel P. Starr, CPA, LL.M., The Journal of Taxation, Vol. 83, No. 2, August 1995). If you do not fall into one of the safe harbors provided by the examples, then a series of "intent tests" will be employed. The IRS will test whether:

1. The partnership is bona fide.

2. Each partnership transaction or series of related transactions is entered into for a substantial business purpose.

3. The form of the transaction is respected under substance-over-form principles.

4. The tax consequences to each partner of partnership operations and of transactions between the partner and the partnership accurately reflect the partners' economic agreement.

5. The tax consequences to each partner of partnership operations and of transactions between the partner and the partnership clearly reflect income.

The abuse that the IRS seeks to avoid in the safe harbor example is an abuse involving a form-over-substance transaction with no real economic purpose, a primary purpose of which is a deferral of tax. As one reads through the much-criticized regulations, it is clear that Thornburg Foundation Realty, unlike most other UPREITs, is not a deferral mechanism. The example cites a limited partnership operating as an UPREIT whose principal purpose is to obtain diversification and liquidity with the deferral of gain recognition, and the IRS has included that example to give taxpayers a safe harbor. If that example passes muster, then an UPREIT such as Thornburg Foundation Realty which does not have the principal purposes of deferral of income and has the purpose of facilitating gifts to charity through substantive economic transactions, clearly passes muster, even under the controversial partnership abuse regulations. So, why did this even come up?

The IRS has informed us in discussions that, as a matter of policy, they will not issue a ruling involving an UPREIT unless the situation presented is identical in every factual detail to Example 4 of the Regulations. We were expressly told that no one was

criticizing the Thornburg Foundation Realty structure. Rather, the IRS felt that its one example in the partnership Anti-Abuse Regulations, Example 4, was all the forward guidance that the IRS should give in that area, and consequently, no letter rulings will be issued that are not "on all fours" with this example. As we say in Texas, "We don't have a dog in that fight," but without putting the two-year provision into the UPREIT documents, we would not have been able to obtain a ruling on any of the other features of the Thornburg Foundation Realty structure. Consequently, we included the provisions. Thornburg Foundation Realty will, however, give a potential transferor the option to be governed by the two-year provisions or to disregard the two-year provision.

In summary, the ruling provides substantial positive guidance to anyone considering such a transaction with Thornburg Foundation Realty. Most of the principal provisions of the arrangement were approved by the IRS, and no direct or implicit expression of concern was voiced by any IRS official that the Thornburg Foundation Realty structure in any way constitutes an abusive giving technique. The discussions were cordial and friendly, and as a result of matters that are not relevant to TFR, the ruling produced two "odd-duck" responses in the Palmer transaction arena and in the two-year holding period area. It seems clear that even if the IRS were to challenge a TFR transaction on the basis of Palmer or the two-year rule (and the IRS gave every indication that it had no interest in testing those issues), the effort by the IRS would fail in the Tax Court. Furthermore, in a "rather be safe than sorry" mode, informal discussions were held with Congressional tax-writing committee staff members, and no abuse was perceived. One key staff member stated that the committees "had no legislative interest" in TFR. Finally, even if an adverse result were reached under Palmer or the partnership abuse rules, the worst case scenario would be the taxation of the inherent gain in the property. In instances where debt exceeds basis, a portion of the inherent capital gain will be realized in all events. More importantly, an adverse result under either of these two provisions should not affect the validity of the charitable remainder trust receiving partnership units or any other aspect of the Thornburg Foundation realty structure.

How great is the risk of encountering a challenge on these issues? I again observe that TFR presented this program to the IRS at the earliest possible moment with full disclosure of its intent to provide a mechanism for overcoming the impediments of LR 915049. The result was a positive response and a positive attitude with no threats of challenge expressed or implied. In my view, estate planners propose and implement for their clients much more risky transactions every day. The IRS is clearly hostile to many of these arrangements. What is the perspective of the IRS toward the TFR technique? It can be summed up by a sincere comment by an IRS official involved in the ruling process that the TFR program "will be good for charities." When compared to planning techniques that constitute mainstays of estate planning practice today, TFR is a low-risk opportunity to address a decade-old concern: the inability to bring real estate, particularly debt-encumbered commercial real estate, back into the mainstream of charitable giving.

Conclusion

Thornburg Foundation Realty has only begun to receive its first property transfers. Dozens are under consideration, but it still will be several weeks if not months before a sufficient number of properties are in place for TFR to start functioning as a full-blown UPREIT. A high level of activity is necessary to make the UPREIT attractive as an investment, and it is on this side of the equation that the efforts at TFR are currently focused. It is anticipated that the UPREIT will have an initial public offering within the next year, depending on the economic environment and other factors. At that time, shares will become freely tradable, except that shares received by charities will be subject to transfer restrictions akin to "Rule 144" restrictions. However, TFR is working on a number of other measures to produce opportunities for charities to obtain liquidity as early as possible after a public offering.

TFR will only enter into transactions involving properties with a value of $1,000,000 or more and a value-to-debt ratio of no less than 2 to 1. The TFR target market is not only individual givers, but also charities that already have a real estate portfolio and wish to reduce it and corporations that have excess real estate and would welcome the opportunity to give these properties to charity in a tax-efficient manner that would benefit society. Consequently, TFR will be operating on many fronts in the coming months. The fundamental premise of TFR is that charities miss out on donations of billions of dollars in commercial real estate each year because of the concerns and constraints described early on in this article. Based on interest expressed to date, that premise seems sound and TFR may very well play a key role in increasing giving to philanthropy each year by billions of dollars. Only time will tell!

Charitable Split-Dollar Legislation Finally Becomes Law

In the January 1999 issue of *CGPN*, we reported on the introduction of HR 630, legislation sponsored by Ways and Means Committee Chairman Bill Archer (R-TX) and ranking minority member Charles Rangel (D-NY). This legislation has now been enacted as part of a tax bill extending certain expiring provisions. Under the provisions of the bill, charitable contributions made

by an individual to facilitate premium payments in a charitable reverse split-dollar arrangement would be denied deductible status under Section 170. The denial of deduction would apply to any transfers made after February 8, 1999 (the date the bill was introduced in the House of Representatives). The legislation also enacts an excise tax equal to the amount of premiums paid on a covered policy which will be assessed against the charity making the payment. This portion of the Act applies to premiums paid after the date of enactment of the legislation, December 17, 1999.

The bill also imposes reporting requirements on charities with regard to any premiums paid. The Treasury is directed to promulgate regulations and forms to enable charities to meet the new reporting requirement. The obligation to report applies to transfers made after February 8, 1999 as well. Specifically, a charity making a transfer in payment of a premium covered by the statute would be required to report to the Internal Revenue Service the name and taxpayer identification number of every beneficiary under the insurance contract with regard to which premium payments are made. Charities would also be required to provide such other information as the Secretary of the Treasury may deem appropriate. A charity failing to file a proper report would be subject to the same penalties otherwise applicable to exempt organizations filing late returns as provided in Section 6033 of the Code.

The Act makes appropriate exceptions for insurance policies owned by charitable remainder trusts, for gift annuities, and for reinsurance contracts for gift annuities.

The enactment of this legislation, together with IRS Notice 99-36 which outlines an aggressive program of attacking charitable reverse split-dollar life insurance policies on the part of the IRS, means that charitable split-dollar life insurance is an idea that never had a time but is gone nonetheless!

GST Trust Creates a Trust in Return

LRs 199939010, 199939011, 199939012.

Those of us who have been around the estate planning world for a while (a long while) recall that the current generation-skipping transfer tax system had an ill-fated predecessor. The Tax Reform Act of 1976 enacted the first generation-skipping transfer tax system, but it was so complicated that it was studiously ignored by all but one single individual that filed a return under the statute, and the Act was retroactively repealed in 1986. The current system was simultaneously enacted in its place. A key date under the new GST tax is September 5, 1985. Irrevocable GST trusts created on or before that date ordinarily would be grandfathered with regard to the GST tax, i.e., no GST tax will be applied against distributions from these trusts.

But what happens if the irrevocable GST trust decides that it wants to create a revocable charitable subtrust? Does the creation of such a trust cost the original trust its exemption from the GST tax? Under the statute, if contributions are made after September 25, 1985, to a pre-existing irrevocable, and thus grandfathered, GST trust, distributions from that trust will be subject to pro rata taxation proportionately based on the value of the assets added after September 25, 1985 to the total assets of the trust. Furthermore, an amendment to a grandfathered trust will cause the trust to lose its exemption if the amendment modifies or otherwise changes the quality, value, or timing of any of the powers, beneficial interests, rights, or expectancies originally provided under the terms of the trust. Under the facts of those rulings, the IRS ruled that the creation of a subtrust with essentially similar provisions to the parent trust, with the parent trust having a right to revoke the subtrust, does not constitute an amendment to the original trust. Accordingly, the exemption from the GST tax which the trust currently enjoys will be unaffected by the creation of the subtrust.

The facts in this ruling are rare enough that they are unlikely to come up frequently, if at all. However, the ruling does serve to remind us of a very important point: a grandfathered GST trust is a very valuable thing, and great care should be utilized when taking any action with regard to the trust to avoid jeopardizing its grandfathered status.

Charitable Lead Trusts Are Reformable, Too!

LR 199936010. We are accustomed to reformation or amendment of nonqualified charitable remainder trusts under Section 2055(e) of the Code to cure defects, but the same provision provides the basis for reformation or amendment of a charitable lead trust that does not meet the requirements for a qualified charitable lead trust.

Here, an individual created a testamentary charitable lead trust which would run for a period of ten years. During the term of the trust, the trustee was given discretion as to distributions to charity. When the trust terminates, the trust is to be equally divided between charities and individuals.

The IRS noted that the trust, as drafted, did not constitute a qualifying charitable lead trust because the payment to charity was not in the form of an annuity or a unitrust amount. There were ancillary provisions to the trust were also inconsistent with a qualified charitable lead unitrust. These included a provision for fixed annual payments to a charity for four years to establish scholarship funds. It was unclear when these payments were to be made during the 10-year term. Consequently, it was proposed

that the trust be reformed to create two separate trusts, one wholly charitable and one a conventional charitable lead unitrust. That trust would pay a 6% unitrust amount for 10 years, with the trust then terminating and passing to the designated non-charitable beneficiaries. The reformation action also provided for the immediate commencement of the four-year scholarship payout.

The IRS noted that the reformation action was timely filed and found further that the reformation would constitute a qualified reformation. Consequently, the reformation was allowed to proceed and a qualified charitable lead unitrust resulted.

"I Disclaim" Exclaimed the Son, and the IRS Said A Qualified Testamentary Charitable Lead Trust Was Born

LR 199947022. An individual died creating a testamentary lead trust providing for an annuity amount determinable by a formula with the remainder passing to the decedent's son. The residuary of the estate passes to the son, but if the son disclaims all or any part of the residuary gift, those assets pass to a second charitable lead trust essentially identical to the first, but with decedent's daughter-in-law as the ultimate beneficiary. Does all of this work?

The IRS said that the use of the formula determining the guaranteed annuity amount was consistent with a qualifying trust. The key is that an objectively-determinable annuity amount be payable under the terms of the will. The fact that the amount is determined by a formula does not affect the validity of the trust. Likewise, Trust 2, with essentially identical provisions, qualifies as well. Furthermore, the court found that the disclaimer provision was a valid disclaimer provision under Section 2518(b)(4), and that consequently, the two charitable lead trusts will be qualifying charitable lead trusts, producing the expected transfer tax deduction and deductible annuity amounts to charity on the trusts' tax returns under the terms of Section 642(c) of the Code.

Final Regulations on Estate Administrative Expenses

The IRS suffered a Supreme Court defeat in *Hubert v. United States,* 520 U.S. 93 (1997), involving the effect of estate administrative expenses on the estate tax charitable and marital deductions. That case held that the payment of such expenses from income generated by assets left to charity or a spouse did not reduce these deductions, rejecting the IRS view that such an application of funds was always a material limitation on the right of the charity or spouse to income from such a bequest. In 1998, the IRS reacted with proposed regulations on the subject. Hearings were held last April, and now the IRS has finalized those regulations, with minor changes, effective for estates of decedents dying on or after December 3, 1999.

Insofar as the charitable deduction is concerned, the regulations divide estate administration expenses into two categories: management expenses and transmission expenses. Management expenses are those incurred in connection with the investment, preservation or maintenance of estate assets during a reasonable period of estate administration. Examples would include investment advisory fees, brokerage commissions and interest. Transmission expenses are those that would not be incurred but for the decedent's death and the resultant necessity of administering the estate. Examples would include attorneys' fees, executors' commissions, and probate fees. Under the final regulations, any administration expenses that fail to qualify as management expenses are categorized as transmission expenses.

The regulation provides that the value of the charitable share in an estate (and hence the estate tax charitable deduction) is reduced by the amount of any estate transmission expenses paid from the charitable share. Management expenses attributable to and paid from the charitable share do NOT reduce the charitable deduction, except where such expenses are deducted on the estate tax return (rather than the estate's income tax return). Finally, estate management expense paid from the charitable share but attributable to a noncharitable part of the estate WILL reduce the allowable charitable deduction.

While that may be more than you wanted to know about estate administration expenses, these regulations are important for planners who handle the administration of decedents' estates. They will have to be taken into account in planning for such expenses and deciding how and from what source they are to be paid.

Not All Nonprofit Organizations Are Charities

Estate of Vesta K. Alward v. Commissioner, T.C. Memo 1999-262. Vesta Alward died in 1994 and her will provided a $50,000 bequest to the Emerson Cemetery in Emerson, Missouri, to be used for historical preservation and maintenance. This cemetery is a Missouri not-for-profit corporation formed in 1961 by members of the Emerson Baptist Church, and its original by-laws stated that of the cemetery's six directors, two would be members of Emerson Baptist Church and two would be members of Emerson Christian Church.

The Tax Court rejected the estate's contention that this was a charitable bequest, and denied the estate tax charitable deduction claimed by the estate. Although the cemetery "may be religiously influenced" it was not solely a church burial ground for the Emerson Baptist Church and was not shown to be devoted to an exclusively charitable purpose.

This is an important point for estate planners to confirm when drafting wills that provide for bequests to unfamiliar nonprofit

entities. In many cases, the testator's aims can be served equally well by providing for a slightly different bequest. In this case, for example, the estate tax deduction would have been preserved if the bequest in question had been left to the church rather than the cemetery. When in doubt, check IRS Publication 78, the two-volume Cumulative List of Qualified Charitable Organizations Described in Section 170(c) of the Internal Revenue Code (also available in a CD-ROM version or on the IRS website).

Make Sure Your Expert is an Expert (and Watch Those Rodents)!

Samuel Jacobson v. Commissioner, T.C. Memo 1999-401. Mr. Jacobson contributed his stamp collection and certain religious articles to an Episcopal Church unit. The stamp collection consisted of 60,484 "first day pages," which were pages including prints, photographs, and other documentary material depicting various historical scenes and events, with theme-appropriate first day of issue stamps affixed to each page. The court emphasized that these were not "first day covers," for which there is a well established market.

Mr. Jacobson hired an appraiser who valued the first day pages at $900,430, and the entire contribution at $949,030; his report offered no methodology for the valuation, no rationale for the prices quoted, and no reference to sales of comparable property. Moreover, the report made no reference to any experience the appraiser had which would support the values he assigned. The donor kept the contributed property in a rodent-infested bakery warehouse, did not insure it, and took no steps to prevent its deterioration. The court observed: "If the contributed property had a value of $949,030 or anything approaching that value, as petitioner claims, petitioner would have treated it with more care."

It is not surprising that the court took a value more in line with that established by the IRS appraiser ($12,973), who had more experience with stamp valuations and prepared a detailed report. Besides the large reduction in the deduction, the court imposed the 40 percent penalty for gross valuation misstatement and a late filing penalty as well.

What is "Charitable"? — State Courts Decide for Themselves

Pittman v. Sarpy County Board of Equalization, Nebraska Supreme Court (No. S-99-063, 12/17/99). Mercy Crestview Village ("MCV"), a nonprofit corporation sponsored by a Catholic religious order, purchased an apartment complex in Sarpy County, Nebraska, in 1996. The mission of MCV is to "create and strengthen healthy communities through the provision of quality, affordable, service-enriched housing" for poor families. Although a property tax exemption was initially granted, an assessor recommended denying exemption for 1998 on grounds the complex was used for low-income housing, which he concluded was not charitable within the meaning of the Nebraska exemption statute. When the County Board approved the exemption, the assessor appealed. After discussing the procedural steps that led to the dispute, the court concluded that the assessor had proven that the County Board's decision was unreasonable and arbitrary. It went on to the merits of the case and concluded that the charitable and educational uses of the property were merely "incidental," even though they provided a valuable community service. The bottom line — no property tax exemption.

This case demonstrates what is a growing trend on the part of state courts to impose their own standards in determining what sorts of activities will qualify for state tax exemptions. Getting IRS to recognize the organization's exemption under Code Sec. 501(c)(3) is only part of the battle!

Favorable Treatment for Charitable Bequests of Deferred Compensation

LR 200002011. In an important ruling, the Internal Revenue Service has for the first time acknowledged that favorable tax treatment is available for deathtime transfers of various types of deferred compensation to charitable beneficiaries.

The ruling involved three categories of deferred compensation for an executive we will call T. T was the founder of a corporation and is now its Chairman of the Board. In the course of his employment with the corporation, T elected to defer receipt of certain amounts: (1) some compensation was payable to him but deferrable at his election under the corporation's deferred compensation plan; and (2) some shares of stock were available to him under a nonstatutory stock option plan, but receipt of the stock was deferrable under the terms of the corporation's deferred stock option plan. In addition, and T had negotiated an arrangement whereby the corporation would pay a death benefit to T's estate, or to beneficiaries designated by him, upon T's death.

In the ruling, T proposed to name qualified charities as the beneficiaries of the deferred compensation and the death benefit, and to bequeath the stock options to charity in his will. The Internal Revenue Service ruled that, while all of these items will be included in T's estate for federal estate tax purposes upon his death, the transfers will qualify for an estate tax charitable

deduction.

More importantly, however, the ruling holds that the income tax burden on all of these items will fall not on T's estate but rather on the charitable beneficiaries that receive them. Since those beneficiaries are exempt from tax under section 501(c)(3), no tax will be payable. Had T left these items to individual beneficiaries, they would have been income in respect of a decedent (or "IRD") taxable to those individuals at ordinary income rates. Here, IRS held that the transfers to charity are sufficient to shift this burden to tax-exempt charities. Prior to this ruling, the IRS position had never been clarified and planners had feared that the income in question might be taxable to the estate of the employee/owner (T, in this case). Thus, this ruling provides welcome clarification that the estate will not be taxed.

Of course, this is only a private letter ruling and, as such, may not be relied upon by taxpayers other than T, the taxpayer who sought and received this ruling. Nevertheless, the ruling's issuance shows the current thinking at the IRS National Office and a contrary ruling on similar facts is unlikely. Let us hope that the Internal Revenue Service will see fit to issue a published Revenue Ruling on this issue, and thus provide guidance that all taxpayers may rely upon.

Gift planners should study this ruling closely as a model for other gifts. While most planners are by now familiar with the manner in which amounts in an Individual Retirement Account or "IRA" can be diminished by upwards of 90% by income taxes due on such IRD, this ruling reminds us that there are other categories of IRD and that they may likewise provide a fruitful source of potential charitable bequests. As with IRA gifts, the use of a charitable beneficiary can dramatically reduce the tax bill that otherwise applies to these assets, and this effect is limited primarily to transfers at death.

Still unresolved is the issue of how such deferred compensation assets will be treated when used for lifetime transfers to such gift vehicles as charitable remainder trusts and charitable gift annuities. Despite the still-unresolved questions, this is a welcome ruling.

Investment Bankers and Charity

An article in the December 20 issue of Barron's describes a forthcoming public offering of securities in Goldman Sachs Group (see "Sweet Charity" by Jack Willoughby, at page 48). Based on recent prices, the securities would bring some $632 million. The article notes that the Goldman Sachs partners have engaged in a bit of timely gift planning, apparently transferring the entire issue to charity prior to the offering (and prior to December 31, certainly).

What may be of particular interest to gift planners is the nature of the donees that will receive the benefit of this offering. Barron's reports that $159 million will go to public charities "ranging from Ivy League colleges to posh prep schools." The balance, amounting to $473 million or 75 percent, will go to private foundations created by the Goldman partners. But wait, there's more. More than half of the $159 million destined for public charities, some $80.5 million, goes to a single charity — The Fidelity Charitable Gift Fund. This charity, ranked number 3 in donations in 1998 is a donor-advised fund formed and administered by the Fidelity Investments mutual fund group. Another $3.26 million will go to a similar charity, the Vanguard Charitable Fund.

The article speculates about the reasons for the Fidelity preference, noting that Goldman Sachs does a lot of brokerage business for Fidelity's mutual funds and that Vanguard reportedly refused to give Goldman partners a volume discount on their management fee. Is this a portent of things to come — perhaps as the nation's new internet zillionaires start to unload their holdings?

Inflation Adjustments for Calendar Year 2000 Announced by Internal Revenue Service

Rev. Proc. 99-42, 1999-46 I.R.B.1

Inflation may seem irrelevant in today's economy, but even modest price increases annually can make substantial differences over time. Inflation still exists, and even though modest, it has its effects on everything, including tax planning. The IRS has its own obligations to make inflation adjustments each year for the standard deduction, personal exemptions, the level at which personal exemptions will be phased out, and numerous other provisions. A number of these provisions are addressed each year in a revenue procedure published at year-end for the coming year. By statute, the inflation adjustments for a calendar year are based upon the average of the increase in the consumer price index for each of 12 consecutive months ending on August 31 of the prior year.

The annual gift tax exclusion, which is currently $10,000, is subject to inflation adjustment in $1,000 increments. However, since inflation for the past two years (the period during which the inflation adjustment provision has been in effect) was insufficient to result in rounding to the next $1,000, the $10,000 amount will remain constant in 2000. Such is not the case for the second number, which is the amount of the GST exemption. Until 1999, the GST exemption was $1 million. Beginning in 2000, the GST exemption is adjusted upwards for inflation to $1,030,000.

For charities, donors, and their advisors, one important inflation adjusted number is the level at which certain itemized deductions will begin to be phased out. For 2000, the inflation-adjusted number is $128,950. How does this number fit into the equation? Specified itemized deductions, which include the charitable deduction, will be reduced by an amount equal to 3% times adjusted gross income in excess of the inflation adjusted $128,950. In the case of a separate return filed by a married individual, the phase out will begin for adjusted gross income in excess of $64,475 per year.

Additional inflation adjustments related to the substantiation rules promulgated in 1993 and their adoption of older rules established in Rev. Proc. 90-12, 1990-1 CB 471 are also established annually. In that revenue procedure, the IRS stated that certain insubstantial benefits provided to the donor would not have to be accounted for in giving the donor a receipt for a gift. Specifically, that revenue procedure provides that no benefit has to be accounted for if the value of the benefit or benefits to a donor in relation to a gift amount is not more than 2% of the value of the contribution or $50, whichever is less. An alternative provision provides that a benefit to a donor can be disregarded if the donor's contribution is $25 or more and the benefits that the donor received in turn constitute a "low-cost article" under Sec. 513(h)(2). A low-cost article is one that cost the charity $5 or less and has the name of the charity, its insignia or logo on the article.

The low-cost article exception is also important for purposes of Sec. 513(h)(1)(A), which provides that unrelated business income will not include these low-cost articles if they are provided to a donor in a manner incidental to the solicitation of charitable contributions.

Each of these numbers is adjusted by inflation annually. The $50 amount described above, referred to as the "$50 benefit," is $74 for 2000. The "$25 payment" limitation is $37 for 2000. Finally, the "low-cost article" limitation is $7.40 for calendar year 2000.

Finally, new inflation-adjusted tax brackets and related information appear below.

In summary, no longer can planners comfortably expect an environment free of changes. Even without a change in the tax law, the ever-multiplying number of inflation-adjusted numbers (witness the Taxpayer Relief Act of 1997 provisions which provided for adjusting the annual exclusion for gift tax purposes and the GST exemption beginning last year). However, fortunately, the IRS provides the numbers we need on an annual basis. We hope that our readers find these relevant numbers in *Charitable Gift Planning News* helpful.

TAX RATE TABLES FOR 2000

MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is: The Tax Is:

Not Over $ 43,850 15% of the taxable

income

Over $ 43,850 $ 6,577.50 plus 28% of

but not over $ 105,950 the excess over

$ 43,850

Over $ 105,950 $ 23,965.50 plus 31% of

but not over $ 161,450 the excess over

$ 105,950

Over $ 161,450 $ 41,170.50 plus 36% of

but not over $ 288,350 the excess over

$ 161,450

Over $ 288,350 $ 86,854.50 plus 39.6% of

the excess over

$ 288,350

s HEADS OF HOUSEHOLDS

If Taxable Income Is: The Tax Is:

Not Over $ 35,150 15% of the taxable

income

Over $ 35,150 $ 5,272.50 plus 28% of

but not over $ 90,800 the excess over

$ 35,150

Over $ 90,800 $ 20,854.50 plus 31% of

but not over $ 147,050 the excess over

$ 90,800

Over $ 147,050 $ 38,292 plus 36% of

but not over $ 288,350 the excess over

$ 147,050

Over $ 288,350 $ 89,160 plus 39.6%

of the excess over

$ 288,350

UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is: The Tax Is:

Not Over $ 26,250 15% of the taxable

income

Over $ 26,250 $ 3,937.50 plus 28% of

but not over $ 63,550 the excess over

$ 26,250

Over $ 63,550 $ 14,381.50 plus 31% of

but not over $ 132,600 the excess over

$ 63,550

Over $ 132,600 $ 35,787 plus 36% of

but not over $ 288,350 the excess over

$ 132,600

Over $ 288,350 $ 91,857 plus 39.6%

of the excess over

$ 288,350

MARRIED INDIVIDUALS FILING SEPARATE RETURN

If Taxable Income Is: The Tax Is:

Not Over $ 21,925 15% of the taxable

income

Over $ 21,925 $ 3,288.75 plus 28% of

but not over $ 52,975 the excess over

$ 21,925

Over $ 52,975 $ 11,982.75 plus 31% of

but not over $ 80,725 the excess over

$ 52,975

Over $ 80,725 $ 20,585.25 plus 36% of

but not over $ 144,175 the excess over

$ 80,725

Over $ 144,175 $ 43,427.25 plus 39.6% of

the excess over

$ 144,175

ESTATES AND TRUSTS

If Taxable Income Is: The Tax Is:

Not Over $ 1,750 15% of the taxable

income

Over $ 1,750 $ 262.50 plus 28% of

but not over $ 4,150 the excess over $ 1,750

Over $ 4,150 $ 934.50 plus 31% of

but not over $ 6,300 the excess over $ 4,150

Over $ 6,300 $ 1,601 plus 36% of

but not over $ 8,650 the excess over $ 6,300

Over $ 8,650 $ 2,447 plus 39.6% of

the excess over $ 8,650

STANDARD DEDUCTION

For tax years beginning in 2000, the standard deduction amounts under section 63(c)(2) are as follows:

Filing Status Standard

Deduction

MARRIED INDIVIDUALS

FILING JOINT RETURNS $ 7,350

AND SURVIVING SPOUSES

HEADS OF HOUSEHOLDS $ 6,450

UNMARRIED INDIVIDUALS

(OTHER THAN SURVIVING $ 4,400

SPOUSES AND HEADS OF

HOUSEHOLDS)

MARRIED INDIVIDUALS

FILING SEPARATE $ 3,675

RETURNS

DEPENDENTS. For tax years beginning in 2000, the standard deduction amount under section 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $ 700, or the sum of $ 250 and the individual's earned income.

AGED AND BLIND. For tax years beginning in 2000, the additional standard deduction amounts under section 63(f) for the aged and for the blind are $ 850 for each. These amounts are increased to $ 1,100 if the individual is also unmarried and not a surviving spouse.

PERSONAL EXEMPTION.

EXEMPTION AMOUNT. For tax years beginning in 2000, the personal exemption amount under section 151(d) is $ 2,800.

PHASEOUT. For tax years beginning in 2000, the personal exemption amount begins to phase out at, and is completely phased out after, the following adjusted gross income amounts:

Threshold Completed

Filing Status Phaseout Amount Phaseout

Amount After

Married filing jointly $ 193,400 $ 315,900

Head of households $ 161,150 $ 283,650

Unmarried individuals $ 128,950 $ 251,450

Married individuals

filing separately $ 96,700 $ 157,950

"Oh! You Mean You Still Want Us to Collect Taxes?"

Recently, the Senate Finance Committee held hearings into widespread reports that the IRS is being less than enthusiastic in collecting tax revenues owed to the government since the IRS restructuring legislation passed last year. Newspapers have been rife with reports of agents allowing millions and even hundreds of millions of dollars of income tax to go uncollected for myriad reasons, including an attitude that unless all of a taxpayer's tax liability could be collected, no tax would be collected at all!

In the recent hearings, Senators who have been active in restricting the IRS' ability to utilize long-used methods for collecting taxes are now anxious to see the IRS start bringing in the dollars. Chairman William Roth stated that "while the IRS is in the throes of this enormous restructuring, it must continue to collect taxes." IRS Commissioner Charles O. Rossotti and his lieutenants testified on this and numerous other matters, assuring the senators that collections would be addressed more vigorously. Given the limitations on the IRS' traditional ability to collect taxes, it will be interesting to see how all this goes. Some estimates have indicated that even with the huge surpluses projected, collections of taxes owed that could be collected with reasonable effort range as high as $70 to $100 billion per year. We will see if this series of hearings produces results.

Members of the Exempt Organizations Committee of the American Bar Association Section of Taxation Address the Issue of Cooperation of State Attorneys General and the IRS

Previously, we have reported on the potential for coordination between the attorneys general and the Internal Revenue Service when the Internal Revenue Service is conducting intermediate sanctions investigations. However, at a recently-concluded meeting of the ABA's Exempt Organization Committee of the Section of Taxation, Marcus Owens, Director of the Exempt Organizations Division of the IRS, indicated that the prohibitions on disclosure found in Section 6104 of the Code present a barrier to the sharing of information at the level desired by the state attorneys general. The attorneys general find this frustrating, but absent new legislation liberalizing the ability of the IRS to share information with state attorneys general, no different outcome seems possible.

New Orleans Move Over: The IRS is the New "Big Easy"

LR 200002029, October 14, 1999. This is one in a continuing stream of rulings allowing for reformations to address "scrivener's errors."

This ruling involves a net income with makeup provision charitable remainder unitrust which the trustee seeks to reform to become a flip trust under the new flip trust regulations. However, the trustee also seeks to reform the document to remove references to "Section 170(b)(1)(A), since it is represented that this provision frustrates the donors' original intent to benefit a private foundation with their gift. The trustee seeks the approval of the IRS and the court to delete references to this Code Section, leaving only a reference to Code Section 170(c) in the document. It is noted that over two years have passed since the trust was signed, and that two amended returns will have to be filed to reflect the disparate treatment for a gift to a unitrust benefiting a private foundation as opposed to a gift benefiting a public charity. All of this said, the court approved the reformation as requested, as did the IRS. The liberality of the IRS' rulings in situations such as this continues to expand at a rapid and almost shocking rate.

"Alice in Wonderland Where Are You?"

LR 199952093, October 7, 1999. For many years, planners would include provisions in charitable lead annuity trust documents allowing accelerated payment of the total annuity obligations provided for under the document. In other words, once the trust was established, the annuity amount payable each year was fixed. If extra funds were on hand, future years' payments could be made early, so that the trust could terminate early with the trust assets passing to the noncharitable beneficiaries. However, in 1983, the IRS indicated that such a provision would disqualify the trust. Rev. Rul. 88-27, 1988-1 C.B. 331, GCM 39676. Now, in this ruling, the taxpayer asked the IRS to rule on the consequences of the trustee's intended accelerated payment of the annuity obligation under the lead trust and the apparent subsequent early termination of the lead trust. Specifically, the IRS was asked to rule whether the early payment of the obligation would result in an application of the private foundation termination provisions of Code Section 507 to the lead trust, whether or not the early prepayment would constitute self-dealing under Section 4941 or whether or not the early prepayment would constitute a taxable expenditure under Section 4945. The IRS ruled favorably on all points.

The ruling does not specifically say that the trust will be terminated early with the amounts being distributed to the noncharitable beneficiaries early. However, that is the strong implication from reading the ruling. Furthermore, the IRS was not asked as to whether or not the prepayment would disqualify the trust. It would appear that the trust document itself did not contain a

prepayment clause, since the presence of the clause would have jeopardized the qualification of the trust from the outset based on existing IRS positions on such arrangements.

Theoretically, this could be a "gotcha" situation where the IRS gives satisfactory answers to the questions posed, but does not volunteer any objections which the IRS has to prepayment of the annuity amount and subsequent termination of the trust. More likely, this is simply a transaction limited to its facts: the document contains no prepayment arrangement, economic circumstances have arisen which allow full, nondiscounted payment of all remaining annuity obligations, and consequently the trustee wishes to make those payments early and then (apparently) terminate the trust. Based on these facts, the IRS rules favorably. How far this ruling can be interpreted as extended is problematic. However, in the absence of even a discussion of the IRS' existing position on prepayment clauses, planners would be wise to not take this ruling farther than it specifically goes.

Church Member Discovers "You Don't Know What You've Got Until It's Gone"

Jack Lane Taylor v. Commissioner of Internal Revenue, T.C. Memo. 2000-17; No. 14021-98 (January 18, 2000). Indiana Baptist Temple lost its tax exempt status on May 8, 1995. In 1996, Jack Lane Taylor donated $8,647 to the church. Nonetheless, Mr. Taylor claimed an income tax deduction in 1996 for the amount donated. The IRS denied the deduction, first because the substantiation rules were not met with regard to the deduction, and secondly, because the church was no longer a charitable organization at the time the contribution was made. The IRS noted that the removal of the church's status as an exempt organization was publicized by the IRS in Announcement 95-35, 1995-19 I.R.B. 14, and that the name of the church was deleted from the list of organizations eligible to receive deductions under Code Section 170. It appears that Mr. Taylor's factual presentation was less than a model of clarity. However, the court surmised that the position that Mr. Taylor was taking in support of his deduction was that because the church was a "church," as opposed to a "corporation," it did not have to meet the requirements of Code Section 170(c)(2) as did other charities. As authority, Mr. Taylor relied upon Section 508(c)(1) in support of his position. However, the court noted that Section 508 is the provision of law which requires would-be charities to seek exemption from the Internal Revenue Service. Section 508(c)(1), relied upon by Mr. Taylor, merely exempts churches from the application process. While the church does not have to apply for recognition of its status as an organization exempt from tax under Section 501(c)(3) and as an organization eligible to receive tax deductible gifts under Section 170(c), the church nonetheless is required to meet the provisions of Section 501(c)(3). Once the IRS Commissioner determines that a church no longer is described in Section 501(c)(3), contributions to the church are no longer deductible under Section 170. Consequently, Mr. Taylor's deduction was denied.

Another Look at the Private Foundation

Although the private foundation is often discussed and considered in conjunction with charitable remainder trusts and other traditional charitable gift vehicles, it is quite different in form and function. Perhaps because of that difference, it is less familiar to many gift planners. But the foundation may be gaining in importance with today's newly-emerging philanthropists, who are said to want more control over their contributions than donors of past generations. In this month's column we will discuss some of the pros and cons of the private foundation and review some of the ways it may be beneficial to both donors and donees. As we shall see, a private foundation can be quite useful in some not-too-unusual situations.

Basic Characteristics

Although the Internal Revenue Code includes (in Sec. 509(a)) a long technical definition of the term "private foundation" for tax purposes, there is no real classification difficulty in most cases. For purposes of this column, we will use the terms "private foundation," "family foundation," and "foundation" interchangeably. The typical example is simply a charitable organization that is created and funded by a single individual or family to support other charitable organizations selected by the creator and his or her family. It may be formed as a nonprofit corporation or a trust. It is exempt from federal taxes under Code Sec. 501(c)(3), and the donor's contributions to it are deductible for income tax, gift tax, and estate tax purposes.

Tax Rules

For many planners, and especially for lawyers, the hallmark of a private foundation is the system of Internal Revenue Code limitations and restrictions that applies to it. Unfortunately, some planners can become so fixated on these complicated tax rules that they overlook the useful aspects of the foundation and discourage their clients who express an interest in creating a foundation.

The first set of these tax limitations for private foundations consists of reduced income tax deductions for contributions for the foundation. Deductions for cash contributions are limited to 30% of the donor's adjusted gross income ("AGI"), instead of the 50% limitation applicable to public charity contributions. Contributions of appreciated property are even more strictly limited. First, most contributions of property to a private foundation are deductible only to the extent of the donor's tax basis, rather than the fair market value. An important exception allows full fair market value deductions for contributions of "qualified appreciated

stock" (generally, any publicly-traded stock) to a private foundation. Even where such deductions are allowable, however, they are limited to 20% of the donor's AGI (versus 30% of AGI for contributions of appreciated property to public charities).

Note: In his 2000 State of the Union Address, President Clinton proposed higher deduction limitations for contributions to private foundations — 50% of AGI for cash gifts and 30% for capital gain property, which would match the limits applicable to public charity gifts.

It is important to note that for many donors, and maybe most donors, these deduction limitations may have little or no effect. So long as a foundation is funded with cash or publicly traded stocks, and the transfers to it do not exceed 20% of AGI, the donor may deduct them in full, exactly as would be the case for a public charity donee.

Another set of restrictions governs the operation and activities of foundations. These rules and limitations are set forth in Chapter 42 of the Internal Revenue Code, and are often referred to as the "Chapter 42" rules. Except for the IRC Sec. 4940 excise tax on investment income (which is really a form of income tax), these excise taxes serve as penalties to prohibit certain actions on the part of private foundation. The following is a simple summary of the principal Chapter 42 restrictions; the provisions themselves are quite complex, with exceptions and special rules far too complicated for purposes of this overview:

- Self-dealing transactions are prohibited by IRC Sec. 4941, which makes it impossible for private foundations and their "disqualified persons" (including substantial contributors and managers, and any related parties) to enter into any sales, leases or other uses of property between them.
- Excess accumulations of income are prohibited by IRC Sec. 4942, which requires a foundation to make distributions each year in prescribed minimum amounts, generally equal to 5% of its investment assets.
- "Excess business holdings" are prohibited by IRC Sec. 4943, which limits the total holdings of a private foundation and all of its disqualified persons in a business enterprise to 20% (35% if control is held outside this group).
- Risky Investments, those which might jeopardize the foundation's ability to carry out its charitable purposes, are prohibited by IRC Sec. 4944.
- Prohibited grants. Various types of "prohibited transactions" are spelled out in IRC Sec. 4945. Examples include grants for lobbying or electioneering, certain grants to individuals or private foundations, and grants for noncharitable purposes.

Each of the penalty taxes described above has a two-stage operation. An initial tax of 5 to 10% of the amount involved in the transaction applies immediately upon IRS assessment. Thereafter, the transaction must be reversed (via repayment, cancellation, or whatever corrective action is appropriate) and, if this is not done, a second-level penalty of 100 to 200% is assessed. Obviously, these rules are not to be taken lightly.

Finally, as mentioned above, a private foundation must pay an income tax of 2% on its investment income, including capital gains on investment assets. This tax can be reduced to 1% if the foundation makes distributions sufficiently in excess of the minimum distribution amounts required by IRC Sec. 4942 described above.

In addition, special return and disclosure rules apply to private foundations. It is worth noting (in case you wondered) that there are no special advantages or benefits that come from classification of a private foundation - only these limitations and restrictions.

Classic Applications for Foundations

Many of the traditional uses of a private foundation are the obvious ones suggested by its function. Understandably, an entity which makes grants of money to charitable organizations finds its greatest appeal among individuals who themselves are frequent contributors to charitable organizations. Such a person may find that a private foundation offers a convenient way to formalize his or her practice of making charitable contributions.

Thus, private foundations are often formed by individuals active in one or more charitable organizations and accustomed to providing contributions on a regular basis. Such an individual can make a contribution of cash or publicly-traded stock, claim a current income tax charitable deduction for the full value transferred, and then cause the foundation to make grants from the foundation to his or her usual charitable beneficiaries on a more leisurely schedule.

It is this increased control that usually makes the foundation appealing to the donor. Consider, for example, a donor who regularly makes significant contributions to her university and to a local art museum. Although she could make outright

contributions to these groups and deduct them in full, she would thereby surrender the contributed funds and would not be in a position to exert any continuing influence over their use by the donee organizations. Alternatively, by putting these funds into a private foundation, the donor can control their disposition indefinitely, but still take an immediate deduction. The foundation has a payout requirement, but this is relatively small, generally equal to 5% of the foundation's investment assets; this requirement can generally be met out of income earned on the contributed funds. The donor may cause the foundation to grant more than this minimum amount to the university or museum, but this is at her option. Also, although the donor has already gotten the benefit of her tax deduction, she may continue to exert some indirect influence over the university and the museum. And whether those organizations accept or reject the donor's suggestions, she and the foundation are free to make subsequent grants to other organizations (even to the exclusion of the initial beneficiaries) if she so desires.

This aspect of the private foundation often fits the needs of a corporation which has or wishes to start a corporate giving program. By using a foundation thusly, the corporation can often manage its charitable giving program more efficiently. The donor corporation budgets for its charitable contributions on an annual basis, then transfers the amount determined to a private foundation created by the corporation. The foundation then makes grants to other charitable organizations, perhaps paying out the funds received from its donor corporation over the next year. Through its control over the foundation, the corporation is able to manage its contribution program efficiently and effectively.

A foundation is often used as part of an estate plan as a means of reducing or eliminating estate taxes. This may have special appeal for wealthy individuals who prefer leaving wealth to a foundation, for purposes which they can dictate, rather than paying the federal government, which they cannot control. Often, such individuals will create a foundation during their lifetime and endow it with relatively small amounts, with a plan to leave it major amounts upon their deaths. Such a foundation is sometimes referred to as a "stand-by" foundation.

All in the Family

Over and above their philanthropic applications, private foundations can offer special benefits in the family context. Most foundations are created by persons of some affluence, and it is families of this sort which often encounter special problems in child raising. Children who are provided with every material advantage, and have few unfulfilled needs and wishes, often encounter difficulty in developing a realistic sense of the value of money and its place in a personal value system. Such a child is often denied the opportunity for self esteem which "less fortunate" children can develop through such responsibilities as household chores, part-time jobs, volunteer work and other opportunities to achieve small successes. This effect can become more pronounced as children grow older. This is particularly true if they have access to such sufficient wealth that they are insulated from the types of choices and mistakes which can help young people develop a mature and responsible attitude toward money and what it can provide.

Some families have found that the creation of a family foundation can help provide their children with experiences which can counteract this effect. As a starting point, children can be given responsibilities in the administration of the foundation and the selection of its grantees. Even very young children are capable of handling tasks in these areas; as they become older, the magnitude of their responsibility can be increased and eventually broadened into investments, long-range planning, and the like.

Such an approach can be used even if the foundation is a small one, with little or no permanent endowment. Even though some experts may advise that a foundation not be formed unless it will have a corpus large enough to produce sufficient income to cover both its grant program and its administrative expenses, this does not mean that every family foundation must emulate the structure of the great national foundations. It may be advisable for the expenses of a smaller family foundation of this sort to be paid directly by the creator, not by the foundation itself, in order to avoid potential problems. The creator should not balk at such a suggestion; indeed, compared with the expense of schooling, lessons, summer camps and the like, this can be one of the least expensive aspects of educating children.

Another role for the family foundation emerges as children become adults, leave home, and perhaps establish families of their own. Parents and grandparents often lament the difficulty of maintaining family cohesiveness as children and grandchildren settle in far-flung locations. The family foundation can provide a focal point for ongoing family projects. By gathering for annual foundation meetings, collaborating on reviews of grant proposals and reaching consensus on grant awards, the family is encouraged, if not forced, to come together and function as a unit on a regular basis. In addition, the larger the foundation the more likely it is that it will be able to make grants which can serve as a memorial to senior members of the family and perpetuate their names.

These uses of a family foundation are often overlooked by gift planners who are more focused on tax and regulatory rules and other factors affecting these entities.

Alternatives to the Private Foundation

For some donors and planners, the private foundation and the attendant tax limitations may be too restrictive to accommodate their plans and intentions. It may be necessary to fund a planned gift with real estate or some other asset that will not produce a full fair market value deduction for the donor. Or plans may call for the proposed entity to hold business interests that the private foundation rules will not permit. Whatever the reason that a private foundation does not fit the bill, there are other alternatives that can provide almost all of the same benefits with just one exception. The hallmark of the private foundation is control; the donor can decide to whom, when, and in what amounts distributions will be made by his or her foundation. If the donor is willing to compromise just a bit, other alternatives can provide most of the other advantages and often on a more economical basis.

The donor advised fund is one alternative that closely resembles the foundation but offers all the advantages of a public charity donee. This alternative is a fund maintained in the donor's name by a public charity to make distributions to other donee organizations. The donor is offered the right to make nonbinding suggestions as to when, to whom and in what amounts those distributions should be made, but the charity administering the fund has the final say. For tax purposes, the donor has made a contribution to a public charity, and thus encounters none of the tax disadvantages of the private foundation. For many donors, the absolute control available from a private foundation is not necessary and this surrender of control to the charity administering the donor-advised fund is fine.

Community foundations and umbrella groups (such as Jewish Federations) are the most familiar organizations offering donor-advised fund programs. Some colleges, universities, and other traditional charities offer them as well, often imposing a requirement that a stated percentage of distributions from such funds must go to the sponsoring organization. Recent years have seen the growth of an entirely new sort of donor advised fund entity — the commercially-sponsored donor advised fund. The largest of these, the Fidelity Charitable Gift Fund, is the third largest charity in the United States in terms of contributions, and other mutual fund groups and financial entities have also created such funds.

Another alternative to the private foundation is the supporting organization. This is an entity much like a private foundation but it is classified as a public charity for tax purposes because of its relationship with one or more other public charities. Although the donor and other disqualified persons may not control such an organization, they can have a voice in its governance.

Donee Considerations

On first examination, one might expect donee organizations to have little or no enthusiasm for private foundations, since they would appear to divert the stream of charitable funds away from donee organizations. Nevertheless, this simplistic and negative viewpoint overlooks several offsetting considerations. First, private foundations represent in the long run an increasingly important source of charitable capital.

Studies suggest that as the baby boom generation inherits the trillions of dollars of wealth amassed by their forebears, they are likely to be more proactive in their philanthropy than previous generations, insisting upon a continuing involvement rather than merely making contributions of money. Since this is the sort of scenario best suited to a foundation, one can anticipate that foundations will become more and more significant in the years to come. For this reason alone, donee organizations would be well advised to maintain contacts with the private foundations in their community (and their local community foundation as well) as potential sources of funding.

In addition, donee organizations should consider preparing an active response to the donor motivations described above. For example, by creating an advised fund program, a donee organization may be able to retain and enhance contacts with donors desiring to obtain some of the benefits available through a private foundation. Such an option will always be more economical and streamlined for the donor than creation of his or her own foundation. Accordingly, an organization may be able to reconcile the donor's considerations with its own needs by providing such easy alternatives.

Finally, the charitable community in a given area is always advanced when more individuals are encouraged to become involved and stay active in the day-to-day struggle to meet current budget needs. This effect should not be overlooked by existing organizations that might otherwise tend to take a defensive and unsympathetic attitude toward the proliferation of private foundations among its interested public.

Summary and Conclusion

The private foundation is a flexible and useful tool for the donor who is an active donor and participant in several charitable organizations and contemplates making major charitable transfers. It also offers a means of introducing children and other family members to charitable endeavors, creating an enduring family institution, and all the while providing the donor and his/her family with control over the distributions to be made to charitable organizations.

There are expenses and complications involved in creating and operating a foundation, but these may be less intrusive than they initially appear. Moreover, the foundation offers a clear route to complete control of the donated funds. For the donor who is

willing to compromise on this point, there are other alternatives such as the donor advised fund or the supporting organization.

And finally, charitable organizations should be aware of the foundations in their area as sources of support, financial and otherwise. An existing donor who considers creating a private foundation may develop into a major contributor and lead to even broader support for the donee organization and the charitable community in general.

Treasury Proposals Include Charitable Incentives

In his State of the Union address, President Clinton called for enactment of increased incentives for charitable giving. The Treasury Department has now released a more complete explanation of the President's proposals, and these include several items of great interest to gift planners.

1. Deduction for Non-Itemizers.

At present, individual taxpayers who claim the standard deduction on their tax returns get no deduction for their charitable contributions, and thus have no tax incentive to increase their giving. The Administration proposes to provide a deduction for significant charitable contributions by these individuals. Under the proposal, non-itemizers could deduct fifty percent of their charitable contributions in excess of $1,000 ($2,000 on a joint return); these thresholds would decrease to $500 and $1,000 respectively beginning in 2006.

2. Increased Percentage Limitations for Contributions of Appreciated Property

Under present law, an individual taxpayer's deduction for charitable contributions of appreciated property is limited to thirty percent of his or her adjusted gross income (twenty percent for gifts to private foundations). The Administration Proposals would increase these limitations to fifty percent and thirty percent, respectively — the same limitations as apply to cash contributions.

3. Clarify Rules for Donor-Advised Funds

Increased use of donor-advised-funds in recent years, including the formation of such charities by financial institutions, has highlighted the lack of clarity in the rules governing such organizations. Accordingly, the Administration Proposals would create a series of new rules governing such funds. Under this proposal, an organization which has more than half of its assets in donor-advised funds would qualify as a public charity only if it met three new tests:

> First, there could be no material restriction or condition preventing the organization from freely and effectively employing the assets in its donor-advised funds for its own purposes. [This means he donor could only advise, and could not direct, grants from the fund.] Importantly, the existence of a material restriction would not be presumed from the mere fact that the sponsoring charity regularly followed the advice received from donors.
>
> Second, distributions from donor-advised funds could be made only to public charities or private operating foundations, or to governmental entities.
>
> And finally, annual distributions from such funds would have to equal at least five percent of the value of the organization's total assets held in donor-advised funds.

A violation of these rules would cause the organization to be classified as a private foundation and subject it to the restrictions applicable to private foundations. The same three rules would apply to donor-advised funds operated by other organizations (i.e., organizations with less than half of their assets in donor-advised funds, such as a fund operated by a university). However, a failure would not cause the entire organization to become a private foundation; instead, only the donor-advised fund assets would become subject to the private foundation rules.

In addition, to prevent distributions from such funds from improperly benefiting donors, the intermediate sanctions rules under Code Sec. 4958 would be amended to make clear that a donor (or other designated adviser) to a particular donor-advised fund would be treated as a disqualified person for purposes of those rules.

Of course, there are other legislative approaches for addressing donor advised funds. One of the more thoughtful ones is set out in this month's Planners' Forum by our guest editor Professor Christopher Hoyt of the University of Missouri - Kansas City School of Law.

4. Reduce and Simplify the Private Foundation Tax on Investment Income

Under present law, private foundations are subject to a two-percent excise tax on their net investment income. This tax rate may be reduced to one percent if the foundation's distributions to charity over the past five years are sufficiently in excess of the

required levels. The Administration Proposals would simplify this tax by repealing the current "two tier" structure and reducing the tax rate to a flat 1.25 percent.

Where, if anywhere, will these proposals go? And when might that happen? Well, Congress appears to be ready to consider at least two of these proposals later this year. Work is starting already on the foundation tax changes and the donor-advised fund rules. Representatives of the foundation world have already expressed concerns over the donor-advised fund proposals. They suggest that the limitations on permissible donees may be too restrictive and, in addition, believe that a single violation of the new rules (especially the prohibition on material restrictions) should not cause a fund to lose its public charity status. Note that these rules would apply to community foundations, and not just the donor-advised funds sponsored by financial institutions.

The other two proposals are more familiar. The increased percentage limits for appreciated property gifts was included in the Senate version of the big tax bill that passed Congress last year and was vetoed by the President, so it's fair to think that this too might move again this year. The deduction for non-itemizers was also in the 1999 bill, but it has very large revenue cost. In addition, its effectiveness is often called into question, since non-itemizers as a group are thought to be relatively unresponsive to tax incentives. Nevertheless, this has been proposed by several Presidential candidates, so it too may see action after the election if not before.

Charitable Contributions – a Political Campaign Issue?

In an earlier issue, we advised that several Presidential candidates had expressed strong support for increasing our present incentives to charitable giving. Between those candidates and the proposals described above from the current Administration, one might conclude that broad support exists for increasing those incentives. In case you missed it, however, that support is not universal.

Former Republican Presidential candidate John McCain recently took aim at the present fair market value deduction for contributions of appreciated property, suggesting that such deductions should be limited to the donor's tax basis in the contributed property. According to McCain, when one taxpayer buys a painting for $1,000 and later contributes it to charity and claims a $10,000 deduction, "thousands of working Americans" must make up the difference. "That's what I'm against," he said.

Who ever thought such issues would arise in a political campaign? Is the planned giving vote more important than we thought? Maybe that's why Mr. McCain is no longer in the race.

Compensation OK for Foundation Board Members

LR 200007039. The Board of Directors of a private foundation consists of several children and grandchildren of the founder, plus a bank as a nonvoting member. There is no paid staff, and heretofore the foundation has not compensated its directors (other than the bank) for their services. Now the individuals on the Board intend to increase their level of activity and devote substantial amounts of time to the foundation, and as a result they desire to be compensated.

"That's fine," said the IRS. Although the Board members are by definition "disqualified persons," payment of compensation as proposed will not constitute self-dealing because, under Code Sec. 4941(d)(2)(E), the payment of compensation by a private foundation to a disqualified person for personal services is not an act of self-dealing, provided the compensation is "not excessive" and the services are reasonable and necessary to the foundation's exempt purposes. This holding was based upon the foundation's representation that the proposed compensation would not be excessive.

Note that this ruling may not be as helpful as it seems, even to the foundation that requested it. Although the foundation stated the amount of the proposed compensation, and the Internal Revenue Service in effect approved that amount, the foundation was required to represent that this figure was not excessive. On audit, the question of whether not this amount is in fact excessive will be up for grabs. As a result, this ruling doesn't do much more than repeat the self-dealing exception in the Code.

Deduction Reduced in Comedy of Errors

Technical Advice Memorandum 200003005. Donor Corporation is in the business of manufacturing books and calendars. In two separate years, it contributed such products to a public charity, and claimed an enhanced deduction under Code Sec. 170(e)(3). That provision allows corporate donor to deduct more than its cost basis for certain inventory contributions to be used by the donee "solely for the care of the ill, the needy, or infants." After reviewing the facts, the IRS held in this technical advice memorandum that Donor Corporation was not entitled to the enhanced deduction.

Why? Well just about everything that could be wrong with this gift turned out to be wrong in fact. For openers, the donor did not

attach Form 8283 to its income tax return as required for either year's contribution. Also, the donor did not establish the required use of the contributed property by the donee. Although it did produce literature about a program of the donee that ships supplies to schools in impoverished areas, it did not indicate what portion of the donated materials were used in that program, nor did it supply any information about how the books and calendars would satisfy any particular need of the needy or infants. The Internal Revenue Service requested this information from the donee charity, but no information was provided. The donee did provide the donor with letters which may have provided the written statement required by the regulations, but these apparently were not received by the donor until after it had filed its income tax returns. Moreover, those letters did not state that the donated property would be used by the donee solely for the care of the older needy or infants, but rather stated in general fashion that donee's mission was to care for the needy. The IRS also disagreed with the valuation method used by the donor. And if all that was not enough, the donor did not obtain the "contemporaneous written acknowledgment" required to support the deduction.

This donor did nothing right, and it seems that the donee did little or nothing to help out. Under these conditions, it is hard to sympathize with the donor's reduced deduction. However, this leaves open the question of whether the deduction might have been allowed if the facts were not so egregious. Gift planners must hope that IRS auditors don't view this ruling as a basis for disallowing deductions in future cases where the parties are less careless.

Private Foundation Can Terminate into Donor-advised Fund for Scholarships

LR 200009048. Private Foundation X proposes to terminate its existence and transfer all of its assets to Community Foundation Y, which is sponsored by a large religious denomination in a particular city. The transferred assets will form a donor-advised fund within Y to be named after a deceased child off the creator of X. This fund will be used to provide scholarships for needy local students to attend parochial and private high schools in the state, with at least three-fourths of the scholarship funds to be used for students at parochial schools. The current trustees of X will be an advisory committee to make nonbinding recommendations to the Board of Directors of Y on the amounts of the distributions and the recipients of the scholarships from the X account. Community Foundation Y will not be bound by this advice, and distributions will be subject to Y's general policies for donor-advised funds. Y may follow the advice of the X advisory committee, but would do so only after it had independently determined that following such advice is consistent with Y's own exempt purposes. Y will have full ownership and control of the transferred assets, and those assets are not subject any material restrictions or conditions on Y's use.

The IRS approved this arrangement, holding that this is a proper termination of X, and would not be subject to the termination tax potentially applicable under Code Sec. 507. The transfer would not be an act of self-dealing, nor would it be subject to any of the private foundation excise taxes.

This ruling demonstrates how a donor-advised fund is supposed to be treated for tax purposes. The granting foundation is treated as having made an unconditional transfer to the community foundation. An individual who make such a transfer is entitled to a charitable contribution deduction for the transfer, notwithstanding his or her continuing right to provide nonbinding advice regarding the transferee's use of the funds. Here, the same treatment was extended to Foundation X for its unrestricted grant to Community Foundation Y. The key to the result in this ruling is that, while the former foundation trustees can give advice and make suggestions regarding the use of funds and the selection beneficiaries, Community Foundation Y is entirely free to ignore such advice and suggestions.

Framework For Donor Advised Fund Legislation

By Christopher Hoyt, Professor, University of Missouri - Kansas City School of Law

Earlier in this issue, we summarized the Treasury proposals for codifying donor advised funds. Whether legislation regarding donor advised funds is necessary or desirable is an open question. If there is to be legislation, many have noted that some of the Treasury Department's ideas should be left on the cutting room floor. One of the people who has given considerable thought to these questions is Chris Hoyt. Chris is a full-time professor of law, a student of gift planning and exempt organizations law, and a professional who writes widely on these subjects and is in great demand as a speaker on gift planning and exempt organizations issues around the country. We are fortunate to have Chris as this month's guest editor, and we believe you will find his perspective on donor advised funds both enlightening and intriguing.

Mission Statement: If we have to have legislation, it should meet the two objectives set forth in the budget proposal:

1. Easy to administer, to encourage growth of donor advised funds ("DAFs")

2. Minimize potential for abuse that benefits donors /advisors

Standards For Any Legislation. The legislation should:

1. clearly define a donor advised fund so that it can be distinguished from a *non-advised fund*,

2. describe the permissible activities of an advised fund,

3. clearly state the duties imposed on charities that administer the funds, and

4. impose sensible penalties on donors who receive personal financial gain from improper use of the funds and on charities that improperly administer the funds.

Six Parts Of Budget Proposal. The budget proposal had six parts:

1. Definition of an advised fund.

2. Requirement that a donor not impose a material restriction

3. Limit grants to U.S. public charities and private operating foundations ("50% organizations").

4. Minimum 5% payout from all donor advised funds (aggregate).

5. sanction on donors: donors would be subject to intermediate sanction laws, and

6. sanction on charities: classification as a private foundation for any violation.

Alternative Suggested Framework:

1. Clearly define donor advised funds and distinguish non-advised funds that are administered by the same charity.

2. Limit grants to U.S. public charities, private operating foundations *and* eligible foreign charities. Grants for charitable purposes to non-charities could be made from *non-advised funds*, even if a donor participated with the non-advised fund.

3. Minimum 5% payout from all donor advised funds (aggregate).

4. Charities have duties to (1) investigate that the organization is an eligible recipient and (2) instruct the grant recipient not to cash the check if there is any financial benefit to the donor or the donor's family.

5. Subject donors to penalties akin to the private foundation taxable expenditure penalties when grants are made from a donor advised fund, at the donor's suggestion, to organizations or individuals that would not have produced a "50%" charitable income tax deduction if the donor had given the money directly to the recipient (with special exemption for eligible foreign charities). To repeat, grants for charitable purposes to non-charities could be made from non-advised funds.

6. Do not impose the intermediate sanctions or material restriction rules. Use simpler sanctions geared toward the grant-making characteristics of donor advised funds instead of the rules designed for executive compensation (intermediate sanctions) and for terminating private foundations (material restrictions).

7. Confirm that a contribution to a donor advised fund qualifies as support for purposes of the public support test.

8. Clarify issues of bifurcated grants and pledges.

9. Repeal the five "favorable" and four "unfavorable" factors in the private foundation material restriction tax regulations. There should be only one law that governs donor advised funds – a new, simple and unambiguous law.

Suggestions For Specific Rules For Alternative Framework:

1. Definition Of Advised Fund

The Treasury Green Book's (the official government publication of the Treasury Department's legislative proposals) definition of an advised fund was:

"any segregated fund (or account) maintained by a charity for contributions received from a particular donor (or

> donors) as to which there is an understanding that the donor or the donor's designee may advise the charity regarding the investment or distribution of any amounts held in the fund."

Please consider the following alternative definition:

> "any segregated fund or account maintained by a charity for contributions received from a donor as to which there is an understanding that the donor, or a disqualified person with respect to the donor, may advise the charity regarding the investment or distribution of any amounts held in the fund. For purposes of this section, a trust that is a component part of a community trust will be considered a segregated fund.
>
> The following funds will not be considered donor advised funds:
>
> * funds with no involvement by the donor or by a disqualified person with respect to the donor,
>
> * funds that receive contributions from numerous unrelated donors (akin to having the fund qualify as a publicly supported charity),
>
> * funds that are controlled by the governing charity (akin to having the fund qualify as a "Type I" supporting organization),
>
> * scholarship funds established by businesses for employees and their dependents, and
>
> * other exemptions to be described in regulations.
>
> Other exemptions would include the exemptions described in the Treasury Green Book:
>
> 1. Funds where grants are limited to uses within the charity (e.g., a university that limits grants for uses that benefit the university).
>
> 2. Grants earmarked at the outset (e.g., United Way donor designation)

Suggestion #1: Clarify that component funds of trust-form community trusts can qualify as donor advised funds.

Suggestion #2: Use a legal standard of "the donor or a disqualified person with respect to the donor". Some donors might have donor advised funds established at their death for their children or grandchildren. The disqualified person definition lists the relationships that Congress has identified as deserving scrutiny.

Suggestion #3: Clearly define "non-advised funds" that might have donor involvement.

The Treasury Green Book's definition of a donor advised fund might include field of interest funds that receive contributions from many unrelated people, including members of a supervising committee.

The definition of a donor advised fund should therefore state that the funds descrobed above will not be considered donor advised funds ("non-advised funds") even when a donor is involved in the grant selection process.

Possible legal standards for these exemptions are outlined in greater detail in the appendix at the end of this paper.

2. Limit Grants To "50% Organizations" And Certain Foreign Charities

I personally agree with the Treasury proposal to limit grants from donor advised funds to 50% organizations, but would modify it to add a class of eligible foreign charities.

Grants for charitable purposes to non-charities could be made from *non-advised funds*, even if a donor participated with the non-advised fund. Such grants would include payments to contractors to rehabilitate historic structures, payments to artists to beautify public areas, etc.

Foreign Charities: Private foundations are permitted to make grants to foreign charities that provide an *Affidavit for Equivalency Determination*. This affidavit qualifies them as a sort of U.S. Section 501(c)(3) equivalent. Reg. Sec. 53.4945-5(a)(5) and Rev. Proc. 92-94, 1992-2 C.B. 507 describe the procedure. See Private Letter Ruling 200010056 (Dec. 14, 1999) for a recent example. One arrangement might be that grants could be made from donor advised funds to foreign charities that produce an Affidavit for Equivalency Determination.

3. Minimum 5% Payout From All Donor Advised Funds (Aggregate).

Nobody has any problem with this. Every community foundation easily meets this standard under current practices.

4. Charities Have Duties To (1) Investigate That The Organization Is An Eligible Recipient And (2) Instruct The Grant Recipient Not To Cash The Check If There Is Any Financial Benefit To The Donor Or The Donor's Family.

These two requirements are reasonable burdens to impose on the administrators of donor advised funds. They meet the objectives in the budget proposal: (1) easy to administer and (2) minimize potential for abuse that benefits donors /advisors.

Level of Investigation: Verifying the public charity/ private operating/ foreign charity status of the organization should suffice. There is no real need to investigate the actual activities of the organization; the donor would have gotten a 50% deduction had the money been given directly to the organization. Even with a minimal level of review, the IRS benefits from having the advised fund make the grant instead of the donor. (Administrators of donor advised funds do the IRS a service by screening grant recommendations. Many people erroneously assume that they can claim charitable income tax deductions for grants to civic organizations or to chambers of commerce (501(c)(4) and 501(c)(6) organizations that do not qualify for charitable deductions). I suspect that many people give directly to these organizations and erroneously claim charitable income tax deductions. The advised funds assure that grants are only made to charities.)

Should there be a duty for greater investigation? In the corporate world, the courts have concluded that directors are allowed to rely on reports from corporate officers but that the directors have a duty to investigate and act if they learn that the reports might not be accurate. Such a reasonable procedure has been adopted by community foundations with respect to advised funds. Community foundations usually contact the donor if they know negative information about the organization, and then the donor almost always rescinds the recommendation. There is no need to have a statute to that effect; it is standard procedure among community foundations and may even be required under "common law" (court-made law).

Sanctions For Violation:

Consider sanctions similar to those imposed on charities under Sections 6115 and 6714 to notify donors of the value of any benefits that they received for a gift (other than de minimus benefits). (There is a sanction imposed on a charity if it fails to disclose in writing to any donor the value of goods or services the donor received in exchange for a gift of $75 or more. This is often referred to as the "quid pro quo" disclosure requirement. The penalty is $10 per contribution, with a maximum penalty of $5,000 per fund-raising event or mailing. Sections 6115 and 6714; Reg. Section 1.6115-1.) For example, a penalty of $100 per violation, with a maximum penalty of $10,000 per year. Repeated and willful violations could subject the charity to revocation of tax-exempt status (something the IRS can do under current law).

5. Subject Donors To Penalties Akin To The Private Foundation Taxable Expenditure Penalties When Grants Are Made From A Donor Advised Fund, At The Donor's Suggestion, To Organizations Or Individuals That Would Not Have Produced A "50%" Charitable Income Tax Deduction If The Donor Had Given The Money Directly To The Recipient (With Special Exemption For Eligible Foreign Charities).

For example, a 10% penalty could be imposed on a donor when a grant from a donor advised fund slips through the screening by the community foundation and there is either a personal benefit to the donor (or disqualified person) or the grant is made to a 501(c)(4) organization or to an individual. The non-deductible portion of the transaction must be undone within a year or there is a 100% penalty.

Again, grants could be made for charitable purposes to non-charities from non-advised funds, even if the donor is involved with these funds.

6. Do Not Impose The Intermediate Sanctions Or Material Restriction Rules. Use Simpler Sanctions Geared Toward The Grant-Making Characteristics Of Donor Advised Funds Instead Of The Rules Designed For Executive Compensation (Intermediate Sanctions) And For Terminating Private Foundations (Material Restrictions).

Reason: The material restriction rules describe when a private foundation has made a completed gift under Sec. 507. By comparison, the determination of when a person has made a completed gift is usually determined under the rules of Sec. 170 (income tax deduction if charitable purposes, delivery of property, etc.) *Let's not complicate the rules by saying that there are different rules to determine when there has been a completed gift to a donor advised fund compared to a completed gift to any other charity*.

Some of the rules on advised funds of community trusts (investigation of potential grant recipient; education of donors) can carry over to administrative provisions that must be done by charities that administer (such funds please see above). They should not, however, be a *prerequisite* to determining whether a donor made a grant to a charity or not.

7. Confirm That A Contribution To A Donor Advised Fund Qualifies As Support For Purposes Of The Public Support Test.

In its 1995 CPE manual and in the trial briefs for the first *Fund for Anonymous Gifts* case, the IRS raised the possibility that it would take the position that grants to intermediary organizations would not qualify as public support for purposes of the public support test. Thus, gifts to designated funds and donor advised funds might not be public support.

This treatment would make Fidelity and all commercial funds classified as private foundations. It could kill the small-scale philanthropy that public charity status currently permits. Many community foundations would also be affected.

It would be helpful if the statute, legislative history or some other legal source would confirm that a contribution to a donor advised fund qualifies as support for purposes of the public support test.

8. Clarify Issues Of Bifurcated Grants And Pledges.

Bifurcated Grants: One of the most common questions I get is whether a donor advised fund can make a bifurcated grant. It always involves buying a table at a charitable event: If a $1,000 payment would produce a charitable income tax deduction of $800, can there be an $800 grant from the donor advised fund and then have the donor pay the $200 non-deductible portion for meals? There is no legal authority in point.

Donor advised funds tend to have much smaller balances and less tax-wise donors than private foundations. In the donor's mind, the donor knows that he or she would be entitled to an $800 charitable income tax deduction if the donor paid for the table outright. Although bifurcated grants are prohibited for private foundations, there is no serious problem with bifurcated grants from donor advised funds. If we want simple laws that do not lay traps for the unwary, bifurcated grants should be permitted from donor advised funds. We do not want laws that approach the complexity of private foundation laws.

Pledges: Again, donor advised funds tend to have much smaller balances and less tax-wise donors than private foundations. We try to teach donors not to make legally enforceable pledges but instead to be more coy. For example, they can say "I will recommend a grant from a donor advised fund" as opposed to "count me in." Still, we are dealing with many less sophisticated people – often the elderly – who do not understand the fine distinctions and often find that they have made a pledge.

Should there be a prohibition on satisfying a pledge from a donor advised fund? A private foundation cannot satisfy a donor's pledge – it is self dealing. [Reg. Section 53.4941(d)-2. See Private Letter Ruling 9610032 (Dec. 13, 1995)].

One might think that it is ethically and legally wrong for a charity to satisfy a donor's pledge on the grounds that it might make the donor richer. Normally a person has taxable income when somebody else pays her or his debt. However, a person does *not have taxable income* when somebody else satisfies a legally enforceable charitable pledge (please see the footnote). [One might think that a donor has taxable income because a legal liability was discharged by a third party (the donor advised fund at a charity), thereby making the donor richer. However, Section 108(e)(2) provides that a taxpayer does not have taxable income if there is a discharge of indebtedness and the payment would have been deductible. Since the payment of a pledge provides a charitable deduction, a donor should not have taxable income if a third party satisfies it. See also Rev. Rul. 64-240, 1964-2 C.B. 172, which specifically provides that a donor will not be treated as the owner of a trust if the trust discharges one of the donor's charitable pledges. For a general analysis of how the IRS views pledges, see G.C.M. G.C.M. 38505 (Sept. 19, 1980). Despite the prohibition on a community trust assuming a donor's pledge (it is a material restriction under Reg. 1.507-2(a)(8)), the IRS issued private letter rulings that concluded that it was not a material restriction for a public charity that received a contribution to satisfy a private foundation's pledge. Private Letter Ruling 9551033 (Sep. 27, 1995). The transaction involved a contribution from a private foundation to a community foundation to permit the private foundation to avoid the Section 4943 excess business holdings tax. Part of the terms of the gift were to satisfy a pledge of the private foundation.]

My point is that many less sophisticated but well-intentioned donors do not understand the nuances of pledges. Had they been more crafty in their wording there would be no pledge and no legal issue of having their charitable interests paid from either an advised fund or a private foundation. I see this situation fairly often. Sometimes the charity rescinds the pledge and you start fresh.

Still, since a donor would not have taxable income from having a donor advised fund pay the pledge, do we need special rules to prohibit pledges? Let's just let the usual rules apply and not have a special law enacted to prohibit pledges from being satisfied from donor advised funds.

9. Repeal The Five "Favorable" And Four "Unfavorable" Factors In The Private Foundation Material Restriction Tax Regulations.

First, there should be only one law that governs donor advised funds – a new, simple and unambiguous law. This requires repeal of the provisions in the private foundation regulations that have different rules for private foundations that terminate into donor advised funds.

Second, there is a fundamental tax policy problem of applying laws to public charities that are drafted for terminating private foundations. Private foundation laws are not supposed to apply to public charities.

Third, the purpose of the material restriction laws is to see whether a private foundation made a completed gift. It interprets Sec. 507. As we all know, the law of whether a human being has made a completed gift is based on the rules under Sec. 170 rather than 507. The material restriction rules are a bad fit for living donors.

Fourth, the material restriction laws are ambiguous and vague. What are a community foundation's "specific charitable needs"? How are they different from a community foundation's general charitable needs? What is the legal standard to determine whether a foundation's educational program or investigation was adequate? Etc. etc. etc.

My friends, do you remember what corporate laws were like before "limited liability companies"? Do you remember how we worried that when the IRS audited a limited partnership it might argue that there were too many "unfavorable factors" so the partnership should really be taxed as a corporation (limited liability, centralized management, perpetual life, transferability of ownership, etc)?

Do you remember how great things became in 1996 when IRS got rid of that and just enacted "check the box"?

The private foundation "material restriction" regulations remind me of those vague favorable and unfavorable factors. This is our chance to clarify the law. Let's dump these rules that nobody -- including the IRS -- understand and adopt simple, objective standards that both we and IRS auditors can easily understand and comply with. If we have to have legislation, let's choose "check the box" simplicity for donor advised funds over the complexity and inappropriate rules in the private foundation termination regulations.

APPENDIX

Details On Definition Of Advised Funds And Non-Advised Funds

The Following Funds Will Not Be Donor Advised Funds ("Non-Advised Funds") Even If The Donor Is Involved In The Grant Selection Process:

1. A fund with no involvement by the donor or by a disqualified person with respect to the donor. Sending a letter to a donor to inform the donor of how the charity spent the gift would not, by itself, cause a fund to be a donor advised fund.

2. A fund that would have qualified as a Sec. 170(b)(1)(a)(vi) publicly supported charity if it had been an independent organization. For purposes of this [subparagraph?], a fund will be a non-advised fund if the public support percentage is 6% or more.

Reason: There are many field of interest funds (e.g., scholarship funds for graduates of a local high school) with numerous contributors. A contribution from a member of the supervising committee should not cause the fund to be classified as a donor advised fund.

One technique to distinguish a bona fide field of interest fund from a donor advised fund is to apply a version of the public support test. Note that the public support test would require regular contributions to the fund; a pure endowed fund would not avoid classification as a donor advised fund if a donor, or a disqualified person with respect to the donor, has any involvement with the fund.

Because of the large number of endowed funds at community foundations and the small scale of some funds, a public support ratio of 6% could be enough to qualify for public charity status rather than the 10% threshold currently used for the public support test. That is, if the public support ratio for a particular fund is in excess of 6%, it would not be classified as a donor advised fund.

Administrative Burden: There is, of course, an administrative burden to compute the test for every fund of a community foundation. However, in most cases the result will be obvious: it is either widely supported or it is a donor advised fund. Rarely should there be a close call that requires the computations.

3. A fund where a majority of the advisory committee is appointed by the charity that administers the fund. The supervising committee cannot have a majority of its members comprised of the donor and disqualified persons with respect to the donor.

This modeled on the Sec. 509(a)(3) supporting organization "controlled by" the publicly supported charity (a "Type I" supporting organization). It would permit endowed funds that might fail the modified public support test, described above, to be exempt from the definition of a donor advised fund.

People should not underestimate the reluctance of donors to give up legal control. Every community foundation in the nation can produce a long list of potential donors who refused to contribute to donor advised funds because they were not willing to sign a document where they gave up legal control over selecting charitable grant recipients.

4. A scholarship fund established by any employer that has more than xxx employees for employees and their dependents.

I personally believe that an individual should not be able to establish a scholarship fund where he or she they can identify the grant recipients. That could permit people to convert non-deductible gifts into charitable income tax deductions.

On the other hand, a business that establishes such a fund for employees and dependents is subject to constraints under the laws that force objectivity. A scholarship fund could in certain circumstances be a taxable fringe benefit to employees. To avoid this result they have to meet certain criteria. [Generally the procedures for a corporation's private foundation are described in Rev. Proc. 76-47, 1976-2 C.B. 670. A public charity generally has to follow the same procedures if it administers a fund for a corporation's employees. See Rev. Rul. 81-217, 1981-2 C.B. 217 and Private Letter Ruling 8816077 (Jan. 29, 1988).]

If there are too few employees, the arrangement will not work. The threshold size where the number of employees and dependents reach the size of a "charitable class" would have to be determined.

Any exemption for scholarships might also extend to a terminating private foundation. The governing body of the private foundation could recommend grant recipients. The IRS approved the practice in Private Letter Ruling 200009048 (Nov. 24, 1999).

Editor's note: This private letter ruling is discussed on Page 4.

5. Such other funds as the Secretary may specify in regulations.

Included would be the situations described in the proposed budget resolution:

> 1. Funds where grants are limited to uses within the charity (e.g., a university that limits grants for uses that benefit the university).
>
> 2. Grants earmarked at the outset (e.g., United Way donor designation).

A Chance to Make a Difference

Many of you will remember Charitable Accord and its successful effort to enact the Philanthropy Protection Act of 1995, the Charitable Gift Annuity Antitrust Relief Act of 1995 and the Charitable Donations Antitrust Immunity Act of 1997, all successfully aimed at ending a scurrilous multi-billion dollar class action lawsuit against America's charities. Many of you were financial contributors (and contributors of time and support as well) to that effort. But Charitable Accord has been and is more than an organization focused on a now-defunct lawsuit. Charitable Accord was active on behalf of charities as the Taxpayer Relief Act of 1997 was enacted. Charitable Accord originated the first bill (and secured the original sponsors) aimed at allowing tax-free rollovers from individual retirement accounts to charities, to charitable remainder trusts and to charities to fund gift annuities. Charitable Accord is active in the current session of Congress on the IRA bill and on legislation to restore the charitable deduction for nonitemizers. In addition, Charitable Accord is active in organizing unparalleled grassroot support for American philanthropy and is active in states across the country on legislation regarding the regulation of charitable gift annuities.

Now, Charitable Accord, which had already been monitoring Congressional staff "trial balloons" on additional regulation of supporting organizations and donor advised funds is acting to assure that legislation on donor advised funds such as that discussed in this issue of Charitable Gift Planning News does not negatively affect community foundations or other charities utilizing this time-honored technique. Charitable Accord recognizes the critical role of community foundations in American philanthropy, and recognizes in turn the critical nature of donor advised funds in fueling community foundations.

To become a member, contact Charitable Accord at 202/463-3957 or 214/969-1428.

Representative Dunn, Senator Coverdell Introduce "Looking Forward by Looking Back" Legislation

A number of bills have been introduced or proposed that would provide a partial deduction to nonitemizers for gifts to charity.

However, the most recent bill is the most unique and may be the most important. The provision for nonitemizer deductions is simple in comparison to other bills introduced so far: a nonitemizer would be able to deduct the first $500 of contributions to charities each year. A married couple would be able to deduct $1,000 in contributions.

The unique aspect of this legislation is in an unrelated provision long-sought by the charitable community: a look-back provision for charitable deductions. Specifically, an individual would be able to make deductible contributions to charity attributable to the prior year up to and including April 15 of the current year. This is similar to the current treatment of contributions to individual retirement accounts.

This is legislation that the charitable community has long sought, and if enacted, it should encourage many individuals, faced with a tax liability payable on their income tax return, to make one last quick contribution to a favorite charity to make that tax liability go away.

The legislation was initiated by Representative Jennifer Dunn (R-WA) and Senator Paul Coverdell (R-GA). As *CGPN* went to press, the bill (to be known as the "Neighbor-to-Neighbor Act") was scheduled to be introduced in both Houses of Congress during the first week of May.

Baptist Temple Continues to Raise the Roof at IRS

In the February 2000 issue of *CGPNews*, we discussed the case of *Jack Lane Taylor v. Commissioner of Internal Revenue*, which was decided in January of this year. In that case, an individual was denied a deduction for $8,647 contributed in 1996 to Indiana Baptist Temple. The deduction was denied because the church had lost its exempt status on May 8, 1995, and the loss of exemption had been published by the IRS in Announcement 95-35, 1995-19 I.R.B. 14. Mr. Lane's primary argument there was that a "church" did not have to meet the requirements of other charitable organizations, particularly "corporations," as described in Section 170(c)(2). In denying the deduction, the IRS noted that churches do enjoy the unique benefit of not having to seek exempt status with the IRS, so that exempt status is presumed for a church. However, upon determination that a church fails to qualify as a charitable organization, once the IRS publishes an announcement to that effect or otherwise meets the procedural rules for setting the date beyond which contributions will not be deductible to the organization, the deductibility of such contributions is terminated. Consequently, Mr. Taylor found himself on the outside looking in with regard to his charitable deduction.

Now, with regard to the loss of tax-exempt status by the church itself, the *New York Times* and *Tax Analysts,* report that some 600 people participated in a protest outside of the Federal Courthouse in Indianapolis recently to support Indiana Baptist Temple in its refusal to pay $5.9 million in back taxes and penalties.

It seems that from 1988 to 1992, the church stopped withholding payroll taxes for its employees. The church had claimed that such withholding taxes were not required because the compensation that its employees received were "love gifts" as opposed to taxable compensation.

The district court ruled against the church, and the IRS set a deadline of April 10, 2000 for payment. After that payment, the assets of the church were subject to levy by the Internal Revenue Service.

While the IRS has not taken action, it appears that action will, in fact, be taken. This is only one of a number of churches that have claimed similar exemptions, claiming to be "New Testament Churches," (a term of art, since by definition a church is a New Testament church....but then we digress: a theology journal this is not!)

The New York Times reports that the church and others like it enjoy the support of both conservative talk show hosts and paramilitary organizations.

Editors Note: Between talk show hosts and paramilitary organizations, it's hard to know which are more dangerous. Suffice it to say that both occasionally go "automatic" and "rapid fire" in their delivery! We will continue to watch this movement with interest (but from a distance with bullet proof vests at hand)!

IRS Publishes "ABCs" on Gifts of Non-cash Property

The IRS has announced the availability of Publication 561 entitled "Determining the Value of Donated Property." With the booming economy, the gifts of property which are both non-cash and non-publicly traded securities continues. This new publication offers guidance as to the definition of "fair market value" for these purposes, and provides examples as to the determination of value of common items falling into this category, such as clothing donated to the Salvation Army. The publication is quite comprehensive in its coverage of this issue, and it is clear that the IRS is trying to use this publication to

separate unintentional overvaluations from intentional abuse. Taxpayers would be well advised to study this publication well before claiming deductions for these property gifts.

Editor's note: Advisors may want to take this opportunity to freshen up as well!

Treasury Announces Business Plan for Calendar Year 2000

Annually, the Treasury issues a business plan of items which it intends to address in that year. Hopefully, in each year, Treasury will complete the items listed. However, that often is not the case. That is particularly true this year with regard to items of interest to the exempt organizations community. Items which are carried over to this year from past years include finalization of regulations governing intermediate sanctions under Section 4958. Also returning to the list is guidance on private foundation termination under Section 507.

A particularly important item relates to the continuation of work on a notice requesting comments on applying rules on unrelated business taxable income, lobbying expenditures, and political intervention to exempt organizations' Internet activities. The activities of charities, including planned giving activities, are exploding across the Internet. How to apply existing laws against a radically new and evolving societal tool such as the Internet presents a challenge for the IRS, but guidance is needed, sooner rather than later.

The IRS has announced a new project relating to the overseeing of information reporting requirements by charities under the new legislation applying to charitable reverse split-dollar insurance plans.

Another new item is a request for guidance and simplification for private foundations making grants to foreign charities. This item has been advocated by the Council on Foundations on behalf of its constituent private foundations.

Finally, under the "Gifts, Estates and Trusts" category is a project calling for final regulations under Section 643 to prevent abuse of charitable remainder trusts. Sadly, the number of abuses that have popped up recently makes it unclear which specific abuse the IRS has in mind when it speaks of this project.

No Fig Leafs to Hide Behind

When Congress passed the Internal Revenue Service Restructuring and Reform Act of 1998, it directed the Joint Committee on Taxation and the Treasury Department to undertake separate studies addressing all existing disclosure provisions in the Code. That study is ongoing, but it has already created dramatic controversy. Volume Two of the study produced by the Joint Committee on Taxation proposes disclosure of nearly all of the documentation exchanged between tax-exempt organizations (except churches) and the IRS. These items would become available, largely without redaction. Included would be private letter rulings and technical advice memorandums, audit results (including closing agreements), pending applications for exempt status, and tax-returns reporting unrelated business income or income earned by taxable affiliates.

These proposals have sparked tremendous controversy in the exempt community and the American Society of Association Executives, the Coalition for Nonprofit Health Care, Independent Sector, and VHA, Inc., have all submitted comments to the Joint Committee on Taxation opposing the breadth of these proposals. How successful opposition to these proposals will be is problematic. Congress is in a mode to encourage more and more openness by charities with regard to the public. They may have very little sympathy for the arguments of charities in this area, even if well founded. However, it must be remembered that while a little sunshine is a good thing, too much sunshine can kill! Let's hope for moderation and accommodation.

IRS Wastes No Time in Going After Charitable Reverse Split-Dollar Arrangements

The Ticket to Work and Work Incentives Improvement Act of 1999 added Section 170(f)(10) to the Code prohibiting charitable deductions for transfers associated with split-dollar insurance arrangements. The rules require charitable organizations to pay penalties equal to the premiums paid on split-dollar arrangements. These would apply to premiums paid after February 8, 1999, the date that Ways and Means Committee Chairman Archer and Ranking Member Rangel introduced initial legislation on the matter.

The new guidance provided by the IRS covers the filing of Form 4720, "Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code," and new Form 8870, "Information Return for Transfers Associated with Personal Benefit Contracts," which the IRS expects to produce in the very near future. This is a form whereby a charity that has entered into a charitable split-dollar arrangement will report the name of the individual or individuals with whom it engaged in the arrangement.

Hopefully, few charities will actually have to file these forms, because one hopes that few charities are actually engaged in charitable reverse split-dollar arrangements. However, for those who are, these forms are not optional, they are mandatory.

Counting the Rich, By the Numbers

The most recent Statistics of Income Bulletin (reflecting statistics from the tax year 1995) issued by the IRS shows that the 4.4 million individuals in America with gross assets of $600,000 or more collectively own $6.7 trillion in assets. This constitutes over 27% of total U.S. wealth. This represents only 2.5% of the total adult U.S. population. Divided by gender, 2.8 million of these individuals are male and 1.6 million are female.

How many millionaires are there today in America? The bulletin says 1.6 million Americans were millionaires in 1995. Based on the rise in the stock market, that number no doubt was dramatically higher on January 1, 2000. As the stock markets continue to gyrate wildly, keeping an accurate total is an impossible task, and one pities the IRS for having to choose the appropriate moment to take a "snapshot" for purposes of statistical analysis.

Tax Shelter Advocates, Apparently Bored with Charitable Remainder Trusts, Foster New Abuses Using Charitable Lead Trusts

An article in the April 5, 2000 Wall Street Journal carries a story headlined "IRS Cracks Down on 'Ghoul Trust' Tax Shelter."

Charitable remainder trusts and charitable lead trusts have their similarities, but they also have their differences. The most obvious difference is the "mirror image" manner in which they operate: lifetime noncharitable beneficiaries followed by charitable beneficiaries as remainderman in the case of remainder trusts, with the opposite format applying to charitable lead trusts. However, there are other differences. Charitable remainder trusts must run for one or more lives in being at the time of a trust's creation or must run for a term not to exceed 20 years from the date the trust is created. The measuring lives in a charitable remainder trust must be the lives that benefit from the trust during its existence.

Charitable lead trusts, on the other hand, have no limit on the term of years that they can run (other than any state law limitations that might be present) and can be measured by one or more lives that otherwise have nothing to do with a given trust, and benefit in no way from the trust. Over the years, individuals who had serious illnesses but had not been pronounced terminally ill have created charitable lead trusts payable for the grantor's lifetime with the remainder going to children or other beneficiaries. Since the individual probably had a life expectancy based on IRS tables greater than their actual life expectancy, this often proved to be wise family planning.

To address abuses in this area, the IRS established regulations defining "terminally ill," since an individual who is terminally ill may not use the actuarial tables otherwise available. What has constituted a "terminally ill person" has changed over the years, and currently, the definition of "terminally ill" in the regulations is a person known to have an incurable illness or other deteriorating condition who has at least a 50% probability of dying within a year. Surviving by 18 months raises a presumption that a person was not terminally ill (and consequently the actuarial tables may be used) "unless the contrary is established by clear and convincing evidence." One would anticipate some contests between the IRS and a decedent's estate over whether a person was "terminally ill" or not at the time the trust was established. What one would not anticipate is that the measuring life would be that of a total stranger sought out for the express purpose of constituting a seriously ill (but not terminally ill) person to do the trick. In issuing regulations to stop the described abuse, the IRS quotes an undisclosed commentator as follows: "This technique (which is not strictly speaking wealth transfer planning for the terminally ill, but rather wealth transfer planning using the terminally ill) falls somewhere between ghoulish and grotesque." As the IRS goes on to add, "Marketing schemes that exploit the misfortunes of some for the benefit of others are contrary to public policy." We think so!

The lead of *The Wall Street Journal* article is as follows, "The Internal Revenue Service is shutting down a tax shelter for the truly privileged: one that lets wealthy people hire strangers to do their dying for them." This particular abuse has been known as the "Ghoul Trust" or the "Vulture Trust." According to *The Wall Street Journal*, some people have been willing to pay as much as $5,000 for the names and medical records of young people who are expected to die prematurely, i.e., within the next two to four years.

Apparently, once the tax shelter promoters have such information, they track down individuals and seek to strike a deal with these strangers on behalf of their rich clients.

To stop this abuse, the IRS has proposed regulations under Section 170, 2055, and 2501. The proposed regulations would limit the term for charitable guaranteed annuity interests and unitrust interests to either a specified term of years or the life of certain individuals living at the date of the transfer. Only the donor, the donor's spouse, or a lineal ancestor of all the remainder beneficiaries may be used as measuring lives.

This should stop what is clearly one of the most grotesque and tasteless abuses to date. However, from this point on, one will not be able to avoid wondering if the person next to them at a continuing education conference was an individual who actually employed this technique!

Court Requires Specificity for Gifts Under a Power of Attorney

The Estate of Sylvia S. Swanson, v. The United States, 85 AFTR 2d Par. 2000-533; No. 97-793T (March 13, 2000). One of the great frustrations in life for a planner is having an individual alive who has done inadequate planning, but who is likewise incapacitated in so far as their ability to do needed planning. Often, planners will advise clients to execute powers of attorney authorizing others to do the planning for them. But depending on the state involved, varying degrees of specificity is required.

Here, the taxpayer, in failing health, gave a durable universal power of attorney to her nephew to manage and dispose of her property. Subsequently, 38 individual $10,000 checks were written by her nephew on her behalf to various relatives with the goal of utilizing the 38 annual exclusions. However, upon audit of the estate tax return, the IRS challenged these gifts.

The Court of Claims upheld the IRS' position, saying that the authority to make gifts of this nature must be expressed in the power of attorney, and could not be implied. In the absence of explicit authority to make dispositions for the purposes of estate planning and reducing estate taxes, the gifts were invalid.

This gift applied solely to estate planning gifts, and did not involve charitable gifts. Nonetheless it is instructive. If charitable gifts are to be contemplated, often courts have been more demanding. Express authority for an agent to make gifts to charity must be provided for in the power of attorney, or else the IRS and the courts may very well challenge it.

Operating in the Margin Spells Disaster

Henry E. and Nancy Horton Bartels Trust et al v. United States, 85 AFTR 2d Par. 2000-572; No. 98-6141 (April 11, 2000). Section 514(c)(1) of the Code describes "acquisition indebtedness" as indebtedness incurred by the organization in acquiring or improving such property; indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

If you have acquisition indebtedness, and income is produced from the property involved, then that income is ordinarily taxable, at least in part, as unrelated debt-financed income which equates to unrelated business taxable income.

In the instance at hand, "such property" was stock traded on the stock market purchased on margin (with funds borrowed from securities dealers with shares given as collateral). The IRS challenged the income from this property as being subject to the unrelated debt-financed income rules. The taxpayers argued that Section 514 applied only to "periodic income" as opposed to gains on the sale of securities. The Second Circuit said that Treas. Reg. Sec. 1.514(b)-1(a) specifically includes gains from dispositions of property in the definition of debt-financed property.

Then, as a last resort, the taxpayers sought to convince the court that the unrelated debt-financed income rules did not apply because the activities engaged in were in furtherance of the exempt purposes of the charity. The court set out the exempt purpose of the charity involved, and pointed out that, other than for the need for income to carry out its exempt purposes, which is present with any charity, neither the acquisition of income in the method involved or the property involved in acquiring the income was related to or furthered the exempt purposes of the charity. In making its ruling, the court noted that it is the property itself, and not the income generated by the property, that makes the activity "substantially related" to the exempt purposes of the organization.

As the stock market continues to attract more and more people, and as more and more people engage in highly risky ventures such as margin trading, even with charitable funds, the risks go far beyond the possibility of incurring unrelated debt-financed income. Such activities can also constitute a fundamental breach of the fiduciary duty of the individuals who enter into these activities on behalf of charities and can result in personal liability for those individuals. Intermediate sanctions may come into play, and where private foundations are involved, the tax on jeopardizing investments may apply.

More could be said on this issue, but hopefully it is clear that while charities have every legitimate reason to be engaged in investing in the stock market, charities are not allowed to engage in all of the activities that individuals may engage in on their own behalf. Margin trading falls beyond any measure of what is acceptable.

CRT Plan Backfires, Produces Big Tax Bill for Donor

John T. Jorgl and Sharon Illi v. Commissioner, Tax Court Memo 2000-10. John and Sharon ran a successful business, Little Rascals Child Care Centers, Inc., with several locations in California. When they informed their attorney they were considering selling Little Rascals and wanted to contribute something to Project Grant a Wish, he suggested a charitable remainder unitrust ("CRUT"). Their accountant agreed, and they ultimately transferred all their Little Rascals stock to a newly-created CRUT with a bank trustee. John and Sharon continued as employees, directors and officers of Little Rascals, and engaged a business broker to help sell the business. Eventually a buyer was found and after negotiations (that somehow didn't involve the trustee, which was the actual owner of the business) a price of $650,000 was agreed upon.

The terms of the sale called for John and Sharon to agree that they would not conduct any similar business within a 100-mile radius for five years. The sales agreement was, necessarily, entered into with the trustee, and the initial draft provided that "the seller" would not compete with Little Rascals, and a handwritten amendment added "and officers" to be sure John and Sharon were included. The agreement allocated $350,000 to the actual purchase of stock and $300,000 to the covenant not to compete; this allocation was calculated by the buyer and was never negotiated between the parties. The full $650,000 was paid into the trust's account. On audit, the IRS contended that the proceeds of the covenant not to compete was taxable to John and Sharon since they and not the trust posed the only real threat of competition for Little Rascals. Not so, said John and Sharon, pointing out that they weren't even parties to the sales contract and the trust received the full proceeds.

The Tax Court applied a substance-over-form and assignment of income analysis to hold that John and Sharon actually earned the income from their agreement not to compete with Little Rascals. Assigning their right to receive the income to the trust did not excuse them from their liability for the tax on that income. The $300,000 amount assigned to the noncompetition agreement in the parties' agreement was deemed binding on the parties, even though the court found the computations used in determining that value to be "in some respects arbitrary." The IRS apparently felt bad about that value too, for it conceded in the litigation that $200,000 was the proper value and the Tax Court used that figure in its decision. One other point in favor of John and Mary — the court excused them from penalties, finding that they had properly relied upon expert tax advice in the Little Rascals transaction.

It is also worth noting another problem that John and Sharon probably didn't consider. The IRS position for some time was that the receipt by a tax-exempt organization (including a CRT) of proceeds from a covenant not to compete was necessarily unrelated business income ("UBI"). Their reasoning — if the recipient <u>did</u> compete, the profits would be business income, so a payment <u>not</u> to compete would be treated the same. The opposing argument was that a payment <u>not</u> to engage in business should not be considered the proceeds of any kind of business, let alone an <u>unrelated</u> business. After many years of pursuing this issue, the IRS finally gave up the view that a covenant not to compete produced UBI in every case. Note the difference the old view could have produced in this case; receipt of any UBTI would have rendered the trust taxable on the full $650,000 proceeds of sale of the Little Rascals operation.

The bottom line here is that a planner cannot afford to undertake a complicated transaction like the sale of a business through a CRT without carefully considering all of the potential ramifications.

When the Donee's Lawyer Draws the Donor's Will - Watch Out!

Estate of Edel, 700 NYS 664, , 182 Misc. 2d 878 (Surrogate's Court, Cattaraugus County, NY, 12/8/99). When Arlene Edel died in 1996, she left a will that she had executed 37 days earlier. That will left $250,000 plus the residue of her estate to the Olean General Hospital. The attorney who prepared that will for Mrs. Edel was also the Chairman of the Board of the Hospital and a partner in the law firm that represented it in legal matters generally. Mrs. Edel's estranged son and her granddaughter objected to the probate of the will, claiming the attorney and the Chief Executive Officer of the Hospital utilized fraud and undue influence to induce her to leave the bulk of her estate to the Hospital. The Surrogate's Court held that the issues presented would have to be resolved by a jury trial, and denied both parties' motions for summary judgment.

The facts demonstrate how difficult a case like this can be, and remind us to consider in advance how our actions may appear after the fact, when viewed from the perspective of later developments. This attorney first prepared wills for Mrs. Edel in 1980, but those wills left nothing to the Olean General Hospital, although forty percent of the residuary estate was left to another hospital later acquired by Olean General. The lawyer joined the Hospital's Board in 1985, and a will he prepared for Mrs. Edel later that year left a thirty percent residuary bequest to Olean General. Nine subsequent wills prepared by this lawyer saw Olean General's share of the residuary estate grow from thirty percent to sixty percent and ultimately to 100%, with an extra $250,000 added in the last will. None of these wills left anything to the son, and the last five specifically disinherited him.

At a 1992 meeting of the Hospital's Board of Directors, on the day after she executed the first will leaving the entire residuary estate to the Hospital, this attorney moved Mrs. Edel's election to the Board as a "corporate member." In 1994, she contacted the attorney about a billing problem with the hospital and a bill of $61.00 was written off, possibly as a result of his pointing out

that she had named the Hospital beneficiary of "a major portion of her estate." Her will provision was mentioned to Hospital officials again in 1995 after she wrote the attorney about her belief that board members would receive a discount on room charges at the Hospital. Later that year, after Mrs. Edel's banker received a letter directing him to liquidate $500,000 of her mutual funds and transfer the proceeds to the Hospital, he sent a memo to his superiors in the bank. That memo expressed concern about the attorney's dual roles as Mrs. Edel's lawyer and Hospital Board Chairman and suggesting the bank not carry out the fund transfer until its counsel had reviewed the situation. Ultimately, the funds were not moved.

The estate argued that the many wills Mrs. Edel executed showed a clear and consistent intent to disinherit her son and leave the bulk of her estate to charity. The son and granddaughter suggest that the surrounding facts showed how the Hospital and the attorney worked together, in violation of the attorney-client privilege, to insure that her entire estate went to the Hospital. In the end, the court found that the evidence would have to be evaluated, and the conflicting viewpoints resolved, by a jury. The presence or absence of fraud and undue influence, and the adequacies of the explanations offered are both questions of fact that must be decided by a jury after a full trial. Both parties' motions for summary judgment were denied.

This case offers gift planners some food for thought. It is not at all uncommon for a donor to ask a donee for legal help with a trust or will, and that is often given with a simple admonition to "have this reviewed by your own attorney." In most situations that is sufficient, but sometimes the parties' relationships are more complicated, as in this case. Where the lawyer is on the board of the donee charity, all parties should be sensitive to even the possible appearance of a conflict of interest. Just who is the lawyer's client? To whom does the lawyer owe primary allegiance? And if the answer is "both parties," better slow down. And keep in mind the potential for misunderstanding when disappointed family members review the dealings between the parties from the standpoint of an allegation of duress or undue influence at a later date, after the donor is gone. Were the parties simply showing concern for the donor or were they attempting to exert inappropriate influence?

Surprise! No Charitable Deduction for Religious School Tuition!

Michael and Marla Sklar v. Commissioner, T.C. Memo. 2000-118 (April 5, 2000). Mr. and Mrs. Sklar sent their three children to private Jewish schools where they received both religious and secular education. Based upon letters from the schools, they claimed that 55 percent of the children's education was religious, and they claimed charitable deductions for 55 percent of the tuition paid. When these deductions were disallowed on audit, the Sklars objected. They stated that they would present evidence that while showing that the IRS has entered into an agreement with the Church of Scientology whereby it would permit Scientologists to deduct comparable payments for religious education.

The Tax Court first noted that, in general, tuition payments to parochial schools are not considered a charitable contribution because the taxpayer making the payment receives something of economic value, i.e., educational benefits, in return. *See Winters v. Commissioner*, 468 F.2d 778, 781 (2d Cir. 1972), affg. T.C. Memo. 1971-290. The court also noted that the Supreme Court decision in *Hernandez v. Commissioner*, 490 U.S. 680 (1989), disallowed charitable deductions for auditing and training fees paid to the Church of Scientology by its adherents on grounds these payments were not contributions. The taxpayers' argument based upon the treatment of Scientologists was dismissed on grounds there was no evidence that the Sklars' situation was analogous to that of the members of the Church of Scientology.

The outcome of this case was not hard to predict. Less clear, however, is what to make of this couple's contention that the Internal Revenue Service position on Scientology payments is discriminatory toward analogous payments made in the context of conventional religions. Tax professionals have long criticized the IRS for not releasing the details of the agreement by which it settled a wide range of disagreements with the Church of Scientology and apparently surrendered its victory in the Hernandez case.

Short-Term Trust Borrowings Do Not Produce Debt-Financed Income

LR 20010061. In a potentially important ruling, the Internal Revenue Service has found that short-term borrowing by a pension trust to finance routine distributions to pension participants do not create "acquisition indebtedness" for unrelated business income purposes. The same reasoning, if applied to comparable borrowings by a charitable remainder trust, would solve a problem faced by many trusts and trustees.

This ruling involved a trust (let's call it "the Trust") created to facilitate the collective investment and reinvestment of funds for various types of qualified employee benefit plans that participate. The Trust is exempt from tax as a qualified plan and as such is subject to the tax on unrelated business income in the same way as a charitable organization. All of the employee plans that participate in the Trust are entitled as a matter of right to have their units of participation redeemed on a daily basis, subject to the trustee's consent. This right of redemption requires the trustee to manage its investments in such a manner that it can produce enough cash on short notice to meet the demands of redeeming participants. To help meet those cash demands, the Trust proposes to establish a $100 million credit arrangement with a bank to enable it to borrow the needed funds on a short-term basis. The trustee of the Trust expects that these borrowings will be infrequent and that they will generally be repaid within 20

business days.

The question posed is whether such borrowing will be "acquisition indebtedness" of the sort that will give rise to unrelated debt-financed income that would be taxable to the Trust. The answer from the IRS — No. A published ruling in 1978, Rev. Rul. 78-88, 1978-1 CB 163, held that temporary securities loans by an exempt organization to a brokerage house did not give rise to unrelated business income. The reasoning was that "Congress did not intend for ordinary and routine investment activities of a section 501(a) organization in connection with its securities portfolio to be treated as the conduct of a trade or business" for purposes of the tax on unrelated business income. The "transitory indebtedness" incurred by the Trust in this current ruling was held to qualify within the holding of Rev. Rul. 78-88 as one of the ordinary and routine activities of the Trust.

Would this same reasoning support a conclusion that a CRT which borrows to meet its payout requirement is similarly protected from unrelated debt-financed income? Maybe, but the circumstances of a typical CRT are sufficiently different from those of the Trust in this ruling that one cannot be sure that the IRS would reach the same result. The cash needs of a CRT to meet its payout requirement are quite different from those of the Trust in this ruling. The CRT trustee knows well in advance how much will be needed and when it must be on hand. By contrast, the needs of the Trust in this ruling are unpredictable and beyond the trustee's control or knowledge. The trustee made a number of other arrangements to enable it to have sufficient cash on hand if and when participant redemptions arise, and this short-term bank arrangement is a contingent plan that the trustee expects to use infrequently. When used, it will normally be repaid within twenty business days. These circumstances are not the same as those faced by a typical CRT that has insufficient liquidity to make a quarterly payout.

Perhaps some CRT needs can be analogized to this situation, but a trustee would be well-advised to consider seeking a ruling on its own facts rather than concluding that the rationale of this ruling is enough to protect it. Nevertheless, this ruling is a welcome glimpse into the IRS thinking and may help some CRT trustees in particular circumstances.

College Sweepstakes Program Won't Spoil Donors' Deductions

LR 200012061. Alumni University will conduct a semiannual sweepstakes program as a fund-raising measure. Tickets will be distributed to the public in a direct mail package consisting of a certificate and a notice that a participant need not contribute in order to be eligible to win a prize. That notice will also indicate that making a contribution will not increase a participant's chance of winning. Participants will return their certificate in a preaddressed envelope, along with a contribution if they so desire.

The IRS ruled that amounts contributed pursuant to this sweepstakes plan would be deductible. A contribution made in exchange for a raffle ticket is not deductible, and there is much authority to this effect. See Rev. Rul. 67-246, 1967-2 CB 104; Rev. Rul. 83-130, 1983-2 CB 148; and *Goldman v. Commissioner*, 388 F.2d 476 (6th Cir. 1967), all cited by the IRS. This plan, however, falls outside this rule since the sweepstakes and any contributions raised will be separate and one need not contribute to participate. Stated differently, the donor will be entitled to deduct any excess of his/her contribution over the charge for the sweepstakes entry and the charge for the sweepstakes entry is zero. Thus, contributions are deductible in full.

Estate Tax Deduction for Bequest to Foreign Musicians' Home

LR 200019001. In a ruling more noteworthy for its facts than its holding, the Internal Revenue Service ruled that the estate of a United States citizen is entitled to an estate tax charitable deduction for a bequest to a foreign charity providing a residence for needy musicians aged 60 and over.

The foreign charity ("FC") also makes rooms available for young music students 18 and older who are indeed of financial assistance and are enrolled in certain music schools located in the same foreign city. These schools have no dormitories, and the students pay FC below- market rents for their rooms. The elderly musicians pay a monthly fee if they are able and, if they die in the FC facility, their estates must reimburse FC for its costs expended in their behalf. Ten percent of the support of FC comes from national and local governments and the balance is derived from public contributions and an endowment fund. FC is not operated for profit and it does not engage in lobbying or political activities.

The IRS found FC qualified as a charitable organization for purposes of the estate tax charitable deduction. Unlike the income tax charitable deduction, which requires that a donee organization be organized in a U.S. jurisdiction, the estate tax deduction has no domestic organization requirement.

S Corporation Stock Gifts and Charitable Gift Annuities: A Workable Combination for the Strong at Heart

Background

As our readers will recall, gifts of S corporation stock to charity have historically resulted in breaking the S election for the corporation. All of this changed with the "Small Business Job Protection Act of 1996." That Act, and the degree to which it

allows S corporation gifts to charity, have been the subject of *Planners' Forums* in July/August 1997 and June 1999. A close reading of the rules might give one the impression that the jobs being protected were those of exempt organizations lawyers and accountants, given their complexity! What Congress gives with one hand, it sometimes takes back with another, at least in part. In this instance, Congress allowed outright gifts to charity, but did not allow gifts to charitable remainder trusts, pooled income funds or charitable lead trusts. Furthermore, the word "UBIT" is literally written all over the statute. All of this being said, and while we can hope for more from future Congresses, there is a life income alternative where gifts of S corporation stock are contemplated, and that alternative is found in the lowly gift annuity. Is the new system perfect? As they say, "You cannot even see perfect from here!" What follows is not for the faint of heart, but it is an effective way of using the S corporation gift rules we have until a future Congress gives us something better!

The New Law

As of January 1, 1998, charities (but not charitable trusts) are able to hold S corporation shares without breaking the S election. New Code Section 1361(b)(7) now allows a Section 501(c)(3) organization and certain qualified retirement plans to hold S corporation stock, effective for taxable years beginning after December 31, 1997.

Section 170(e)(1) is amended by adding a new sentence at the end of that paragraph: "For purposes of applying this paragraph in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of Section 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer."

Subsection 512(e), "Special Rules Applicable to S Corporations" is added to the Code. All income distributable to a charitable S corporation shareholder will be treated as unrelated business taxable income (UBTI) from an asset deemed in its entirety to be an interest in unrelated trade or business. Consequently, "(i) All items of income, loss, or deduction taken into account under Section 1366(a), and (ii) any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization."

New Section 512(e)(2) entitled "Basis Reduction" provides as follows: "Except as provided in regulations, for purposes of paragraph (1), the basis of any stock acquired by purchase (within in the meaning of Section 1012) shall be reduced by the amount of any dividends received by the organization with respect to the stock"

Enter Gift Annuities

An example of the interrelating rules and issues which will be at play in a typical (?) gift annuity initiated with S corporation stock after December 31, 1997, will be helpful. Assume stock of a company with an appraised value of $100,000 is transferred to charity by a 70 year-old in return for a charitable gift annuity. The donor's basis in his stock is $60,000. The American Council on Gift Annuity Rate for a 70 year-old is 7.5%. However, the charity realizes that it is receiving an illiquid asset, and that it will have to bear the burden of payments if it takes longer than expected to sell the asset or if the asset produces a lower sales price than expected. Furthermore, since this is S corporation stock, the charity realizes that a significant portion of the appreciation of the stock will end up being paid to the government in tax on UBTI. (A trust pays taxes at trust tax rates, while a corporation pays taxes at corporate rates.)

Consequently, the charity agrees to pay a rate of only 6% on the $100,000 value of the property transferred. This significantly reduced rate takes into consideration both mitigating factors described above. As a result, a $100,000 gift of appreciated property with a basis of $60,000 and a 6% annuity rate based on a discount rate of 8.2 percent will produce a charitable deduction of $54,638. Furthermore, the annuity of 6% or $6,000 will be taxed as follows: $1,710 tax-free income, $1,140 capital gain income, $3,150 ordinary income.

The Donor's Perspective

For the donor, it is important to note that the new provision of Section 170(e)(i) relating to the donor's deduction applies only to the calculation of the donor's deduction. No similar reference is made to Section 1011 or 1012 of the Code or any other relevant section. Consequently, from the donor's perspective, the gift is treated as one of appreciated stock except for charitable deduction purposes, and reduction in the charitable deduction by the ordinary income items referenced in Section 751 is the only apparent consequence of the new provision. The ordinary income element in the new sentence added to Section 170(e) refers to the assets which produce ordinary income on a sale by a partnership. These include, among others, unrealized receivables, substantially appreciated inventory and depreciation recapture. If we assume that $15,000 of the appreciation in this $100,000 stock gift is attributable to ordinary income items covered by the new sentence added to Section 170(e), then for purposes of computing the donor's deduction only, the gift value of the annuity transaction will be reduced.

Two possible means of making this calculation are present. First, the $100,000 could be reduced by $15,000 and a gift of $85,000 will be assumed to have been made by a 70 year-old in return for an annuity of $6,000. Consequently, this calculation

produces a charitable deduction of $40,016. Since this is still a gift of appreciated property, the deduction may be used to offset up to 30% of adjusted gross income with a five-year carryover of any excess.

Alternatively, and probably more correctly, Treas. Reg. Secs. 1.170A-4(c)(2) and 1.170A-4(d), Example (5), would probably provide for allocation of the ordinary income amount between the sale portion of the transaction and the gift element of the transaction according to the formula set out earlier for bargain sales generally. Here, that would mean that a calculation would first be made on a full $100,000 gift. A charitable deduction amount of $54,638 results. Consequently, the investment in the contract is $45,362. Proration of the $15,000 between the charitable deduction amount and the investment in the contract will only effect the charitable deduction. Specifically, the charitable deduction will be reduced by the prorated ordinary income amount of $8,196, leaving a net charitable deduction of $46,442. Note that with regard to the sale portion of the gift annuity, the basis reduction provisions of the new law discussed above apply.

Testamentary Gifts of S Corp Stock

In testamentary gift annuities, it should be noted that a step up in basis in gifted S corporation stock will be received by the decedent’s estate, so that no tax consequences affecting the charitable deduction will occur. Furthermore, no reduction in the estate tax charitable deduction would be incurred because the new provision in Section 170(e)(1) has no counterpart in Section 2055. Finally, the charity should have little or no UBTI, assuming a relatively quick sale, since the step up in basis will result in very little if any gain on a sale of the property.

Conclusion

All of this having been said, and as unattractive as the new provision may be with its draconian UBTI rules providing for both full UBTI treatment for any income received from S corporation stock held by a charity and UBTI on the gain of the sale of the S corporation stock, the gift annuity alternative may still be somewhat attractive. However, if a gift of S corporation stock is contemplated because of an imminent sale of the corporation, it may be wiser for the donor to break the S election just before the gift to charity and the subsequent sale of the corporation. Since the S corporation status would be broken upon the sale anyway, if the shareholder is a nonqualified shareholder such as a C corporation, breaking the S election early will have no additional adverse consequences and it may allow for certain prorations of items that would not otherwise be available.

Moreover, the gift would then become one of C corporation stock so that the donor would be able to take a full fair market value deduction for a long-term capital gain property gift with no reduction for "ordinary income" items. Furthermore, since the charity can feel relatively confident of a quick turnover of the stock given the prospect of sale, the charity may ask for little or no reduction in the annuity payment. So, in summary, the S corporation rules for charities will be challenging and entertaining (if such a thing is possible!) for both the planner and the giver. But, adding gift annuities to the mix may make braving these rules more worthwhile!

ADDENDUM

What follows is the most recent "snapshot" of gift annuity regulation by the states. It is based upon a regular survey conducted by Frank Minton, President of Planned Giving Services, Seattle, Washington. It has been modified by the authors of this paper to reflect the most recent state actions, and any misstatements are attributable to the authors alone, and not to Mr. Minton.

STATE REGULATORY CATEGORIES April 10, 2000

Charitable Gift Annuities

I. State law requires certification, reserve and annual filing (10):

Years in Board Disclos. Reserve Annual Investment Notes:

State operation resolutn. in agrmt. required filing limitations

AR 5 yes - - - yes yes less strict1 1 Rules apply to reserves for all states

CA 10 yes - - - yes2 yes strict2 2 CA annuitants only

HI 10 in
HI - - - - -
- yes yes -

- - Law requires $5 million of assets in Hawaii

MD 10 in MD - - - yes yes yes - - -

ND - - - - - - - - - yes yes3 - - - 3 Submission of audited financial statements

NJ 10 yes - - - yes yes strict4 4 Rules apply to reserves for all states

NY 10 yes - - - yes yes strict5 5 Rules apply to reserves for all states

OR 20 in OR6 - - - yes yes yes - - - 6 Certain types of charities

TN ----- yes yes yes yes yes

WA 3 - - - - - - yes yes - - - Requires $500,000 of unrestricted net assets

WI 10 - - - - - - yes yes less strict7 7 Rules apply to reserves for all states

II. State law provides for blanket or conditional exemption (30):

Years in Board Disclos. Reserve Notice Avail. Notes:

State operation resolutn. in agrmt. required to state Assets

AL - - - - - - yes - - - yes - - - Exemption granted by Securities Dept.

AZ - - - - - - yes - - - - - - - - -

CO 3 - - - yes - - - - - - - - -

CT 3 - - - yes - - - yes $300k

FL 5 - - - yes yes yes - - - Investment limitations in some cases. If complied with insurance laws, Securities Commission willing to grant exemption letter, although no basis in law exists for such exemption letters

GA 3 - - - yes - - - yes $300k

ID 3 - - - yes - - - yes $100k

IL 208 - - - - - - - - - - - - $2 mil.8 8 Waived if annuities reinsured

IN - - - - - - - - - - - - - - - - - -

KS - - - - - - - - - - - - yes - - - Exemption granted by Securities Dept.

KY - - - -
- - - - - - -
- - - - - - -
Certain charities must file copy of Form 990

LA - - - - - - - - - - - - - - - - - -

ME 5 - - -
- - - - - - -
- - - - -
Must be qualified as a foreign corporation

MA - - - - - - - - - - - - - - - - - -

MI - - - - - - - - - - - - - - - - - -

MN 3 - - -
- - - - - -
yes $300k Exemption granted by Securities Dept.

MO 3 - - -
yes9 - - -
yes10
$100k 10 Notification currently not being accepted

NE 3 - - -
- - - - - - -
- - - - -
Gift annuities are exempt under state insurance law. The Securities Dept. has asserted jurisdiction, which is questionable but will grant

Issuer-Dealer exemption to charities with offices in Nebraska

NV 3 - - - yes - - - yes $300k

NH 3 - - - yes yes yes $300k Annuity rates must not exceed ACGA recomnd.

NM 3 - - - yes - - - yes $300k11 11 Either in unrestricted assets or reserve fund

NC 3 - - - yes - - - yes $100k

OH - - - - - - - - - - - - - - - - - - Agreement signed by both donor and charity

OK 3 - - - yes - - - yes $100k Annual submission of audited fin. statement

PA 3 - - - yes yes - - - $100k Must comply with PA char. solicit. law

SC 5 - - - - - - - - - - - - - - -

SD 5 - - - yes - - - - - - - - - Exemption applies to SD charities only

TX 3 - - - yes - - - yes $100k

UT - - - - - - - - - - - - - - - - - -

VA 3 - - - yes - - - - - - $100k Also need an "Order" from Securities Commission

9 Although the statute was declared unconstitutional (the title of the original bill was not clearly stated and the bill contained more than one subject) legislation is expected to be reintroduced. Therefore, we recommend continuing to include disclosure language.

III. State law does not specifically address gift annuities (11):

AK DE D.C. IA MS MT RI VT* WV WY

* Legislation introducing the NAIC Model Exemption Act will be introduced in January.

Is the Estate Tax at Death's Door?

We are accustomed in recent years to assaults on the tax system, whether those attacks take the form of the attempted repeal of the income tax or the attempted repeal of the transfer tax system. Usually these proposals, when acted upon by Congress, are merely posturing for important constituents and future elections. However, on some occasions, and this is one of those occasions, one gets the feeling that something momentous may be about to occur.

Legislation has moved quickly through the House, approved by a veto-proof majority, to abolish the transfer tax system. The Senate quickly followed by passing an identical bill by a vote of 69 to 39. At the deadline for submission of this paper, indications were that the President would receive the bill from the Republican Congress after the Republican National Convention, whereupon he would veto it.

The fate of this legislation, which will certainly be introduced promptly upon the convening of the new Congress in January 2001, depends solely upon the outcome of the Presidential election, absent a change of earthquake-like proportions in the make-up of the Congress.

The maneuvering on this legislation, in public and behind the scenes, would rival any novel for its intrigue and likewise would rival any political campaign for its exaggerations, overstatements, misstatements and exercise of raw power.

In the end, this year's effort is likely a mere predicate to next year, when there may be no president to veto the legislation. If one believes current opinion polls, the Republican party will control the White House and both Houses of Congress next January, and they will have advanced to those positions while promising repeal of the transfer tax system. It may be that a careful analysis of the effects of total repeal on society and a more pragmatic assessment of the true cost of repeal ($50 to $70 billion per year and rising) may result in a significant increase in the size of estates that are exempt from tax as opposed to total elimination of the transfer tax. For instance, numerous publications have noted that half of the estate tax is paid by estates in excess of $5 million, and half of the estate tax dollars paid in 1998 were paid by the 2900 richest estates. However, a more probable result, in the event that a Republican government is installed, will be prompt and total repeal of the transfer tax system. The last President Bush learned a lesson about promises regarding taxes not being kept. One can be sure that the son has learned by the father's experiences, and that having promised repeatedly to repeal the transfer tax system, he will do it. And it won't take 10 years. And Congress will be with him all the way.

What follows is the House Ways and Means Committee staff explanation of the transfer tax repeal legislation passed by Congress.

Death Tax Elimination Act of 2000

EXPLANATION OF PROVISION

Beginning in 2010, the estate, gift, and generation-skipping transfer taxes are repealed. After repeal, the basis of assets received from a decedent generally will be the basis of the decedent (i.e., carryover basis). However, $1.3 million of transfers from decedents to any beneficiaries will receive a step up in basis. An additional $3 million of transfers from decedents to surviving spouses also will receive a step up in basis. For these purposes, the executor will elect which assets receive a step up in basis. The $1.3 million and $3 million amounts are adjusted annually for inflation incurring after December 31, 2010.

Prior to repeal of the estate, gift, and generation-skipping transfer taxes, the estate and gift tax rates are reduced as follows. Beginning in 2001, the estate and gift tax rate above 53 percent (i.e., the 55-percent rate) and the 5-percent surtax, which phases out the benefit of the graduated rates, are repealed. Beginning in 2002, the rate in excess of 50 percent (i.e., the 53-percent rate) is repealed. In 2003 through 2006, each of the estate and gift tax rates are reduced by 1 percentage point, per year. In 2007, each of the estate and gift tax rates are reduced by 1.5 percentage points. In 2008 and 2009, each of the estate and gift tax rates are reduced by 2 percentage points, per year. No estate and gift tax rate is reduced below the lowest individual income tax rate for unmarried individ uals (other than surviving spouses and heads of households), and the highest estate and gift tax rate is not reduced below the highest individual income tax rate for unmarried individuals (other than surviving spouses and heads of households). The highest estate and gift tax rate in effect for a given year is the generation-skipping transfer tax rate for that year. From 2003 through 2009, the State death tax credit rates are

reduced in proportion to the reduction in the estate and gift tax rates.

Beginning in 2001, the unified credit is replaced with a unified exemption amount. The unified exemption amount is determined as follows: in 2001, $675,000; in 2002 and 2003, $700,000; in 2004, $850,000; in 2005, $950,000; and in 2006 and thereafter, $1 million. For decedents who are not residents and not citizens of the United States, the exemption will be the greater of (1) $60,000 or (2) the portion of $175,000 which the value of the decedent's U.S.-situs property bears to the value of the decedent's worldwide gross estate.

EFFECTIVE DATE

The unified credit is replaced with a unified exemption, the 5-percent surtax is repealed, and the rate in excess of 53 percent (i.e., the 55-percent rate) are repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2000. The estate and gift tax rate in excess of 50 percent (i.e., the 53-percent rate) is repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2001.

The additional reductions of estate and gift tax rates and of the State death tax credit occurs in 2003 through 2009.

The estate, gift, and generation-skipping transfer taxes are repealed and the carryover basis regime takes effect for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2009.

1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips (sec. 401 of the bill and sec. 2632 of the Code)

EXPLANATION OF PROVISION

Under the bill, generation-skipping transfer tax exemption will be automatically allocated to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

A generation-skipping transfer trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless: The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before 1 or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46; The trust instrument

provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals; The trust instrument provides that, if 1 or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of 1 or more of such individuals or is subject to a general power of appointment exercisable by 1 or more of such individuals; The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer; The trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or The trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual may elect not to have the automatic allocation rules apply to an indirect skip, and such elections will be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual may elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and may elect to treat any trust as a generation-skipping transfer trust with respect to any or all transfers made by the individual to such trust, and such election may be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

EFFECTIVE DATE

The provision applies to transfers subject to estate or gift tax made after December 31, 1999, and to estate tax inclusion periods ending after December 31, 1999.

2. Retroactive allocation of the generation-skipping transfer tax exemption (sec. 401 of the bill and sec. 2632 of the Code)

EXPLANATION OF PROVISION

Under the bill, generation-skipping transfer tax exemption may be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor may allocate any unused generation-skipping

transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The provision allows a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption is allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

Holy Moley! — "Politically Incorrect" Church Loses Exempt Status

Branch Ministries, et al. v. Commissioner; 85 AFTR 2d Par. 2000-066; No. 99-5097 (May 12, 2000). For the first time in its history, the Internal Revenue Service has revoked the tax-exempt status of a bona fide church because of its political involvement. Branch Ministries, Inc., operates the Church at Pierce Creek in Birmingham, New York. On October 30, 1992, just four days before the national presidential election, the Church placed full-page advertisements in USA Today and the Washington Times, urging voters not to support then presidential candidate Bill Clinton because of his views on various moral issues. At the bottom of the advertisements the Church welcomed contributions to allow them to defray the cost of the media placements.

The IRS revoked the Church's section 501(c)(3) tax-exempt status, stating that the advertisement constituted a prohibited intervention in a political campaign. The Church filed suit, relying on section 7611 to contend that once a church is granted section 501(c)(3) status, the IRS lacks the authority to revoke that status unless the IRS determines that it is no longer a bona fide church. Rejecting this argument, the district court clarified that section 7611 allows the IRS to revoke the exempt status of a church that is not exempt "by reason of section 501(a)." Section 501(a), in turn, refers to subsection (c)(3), which precludes organizations that "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." On appeal, the Court of Appeals for the District of Columbia affirmed the authority of the IRS to revoke the exempt status of a bona fide church.

The Church also argued that the IRS had discriminated against the Church by selectively targeting it for the church tax examination. Both courts ruled that their was no discriminatory effect from the Service's decision to prosecute the Church and that the Church had failed to demonstrate that it was similarly situated to other churches who had asserted a political view without losing exempt status.

In its opinion, the Court of Appeals makes an interesting point that

even though the Church has rightfully lost its exempt status, it will not necessarily be liable for tax because section 102 excludes gifts from gross income. Further, because of the unique treatment churches receive under the Code, the revocation will likely be more symbolic than substantial, noting that if the Church refrains from future political intervention, it may hold itself out as a 501(c)(3) organization and receive all of the benefits of that status. In that case, all that would be lost would be the advance assurance of deductibility for the Church's contributors.

It is certainly uncommon for a church to actually request a letter from the IRS recognizing its tax-exempt status. In this instance, however, the Church did request and receive an exemption letter which was revoked in this action. Most churches, however, simply choose to operate under the allowed assumption (subject to challenge) that they have tax-exempt status. The Court made the point that this inherent status unique to churches would apparently still be available to the Church in this instance. For any other type of charitable organization not benefiting from this inherent status, the formal revocation of its exempt status by the IRS would likely mark the end of its tax exemption and eligibility to receive tax deductible gifts.

Property Swapping With Charity? Don't Even Think About a Deduction

Robert E. Signom II, et ux. v. Commissioner; T.C. Memo. 2000-175; No. 14764-98 (May 26, 2000). The Tax Court denied Mr. and Mrs. Robert Signom a charitable deduction for the cancellation of property interests purportedly passing to the University of Dayton pursuant to a complex, multi-party transfer of assets in which the couple also received other properties.

The University of Dayton was gifted real property for which the Signoms held a lease interest and an option to purchase. In time, the University determined that it would benefit by selling the property in question and acquiring other properties adjacent to the campus which were owned by Mr. Felman. A series of negotiations between the Signoms, Felman and the University resulted in an exchange transaction in which (1) the University would sell its property to Felman, (2) Felman would sell to the University his property which was adjacent to the campus, and (3) the University would acquire yet another piece of real property to be transferred to the Signoms as a part of the total transaction. As a condition to this arrangement, it was agreed that the Signoms' purchase option would be terminated prior to Felman's acquisition of the University's property.

The Signoms secured a qualified appraisal for the purchase option and the leasehold in the amount of $111,500. They claimed a charitable deduction for this amount, listing the property on Form

8283 as an option to purchase real estate at less than fair market value.

In denying the deduction, the Tax Court ruled that the termination of the Signoms' property interests was not separate from the final exchange transaction among the three parties and was, in fact, an integral part of that final exchange transaction. As a result, the quid pro quo that the Signoms' received in the exchange valued more than the claimed charitable deduction. Therefore, the Court found that the cancellation of the Signoms' property interests did not constitute a contribution or gift of property to the University within the meaning of section 170(c).

The Church also argued that the IRS had discriminated against the Church by selectively targeting it for the church tax examination. Both courts ruled that their was no discriminatory effect from the Service's decision to prosecute the Church and that the Church had failed to demonstrate that it was similarly situated to other churches who had asserted a political view without losing exempt status.

In its opinion, the Court of Appeals makes an interesting point that even though the Church has rightfully lost its exempt status, it will not necessarily be liable for tax because section 102 excludes gifts from gross income. Further, because of the unique treatment churches receive under the Code, the revocation will likely be more symbolic than substantial, noting that if the Church refrains from future political intervention, it may hold itself out as a 501(c)(3) organization and receive all of the benefits of that status. In that case, all that would be lost would be the advance assurance of deductibility for the Church's contributors.

Change in Charitable Purpose Doesn't Necessarily Affect Exempt Status

LR 200020057. A nonprofit corporation, originally organized for the purpose of providing a secondary market for the acquisition of student loan notes, sought to expand its charitable purpose to include a variety of educational programs and services. Newly offered services included training sessions for students seeking financial aid, grant making and lending to prospective students, and consultation with colleges and universities regarding the administration of financial aid programs. To implement these new activities, the nonprofit made an election under section 150, transferring all of its student loan notes to a newly formed subsidiary and amending its articles of incorporation and bylaws to reflect its revised charitable purpose.

The Service determined that the charity was originally organized, and after its election and transfer, continued to be operated exclusively for charitable and educational purposes by providing

various financial assistance programs and other services in support of education. Section 1.501(c)(3)-1(c)(1) of the regulations states that an organization will be regarded as "operating exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such purposes described in section 501(c)(3) of the Code, but will not be so regarded if more than an insubstantial part of its activities do not further an exempt purpose. Applying this section of the regulations, the Service concluded that the charity's change in activities, purpose and governance did not prevent it from operating exclusively for charitable purposes.

Because the newly offered programs and services were found to be substantially related to the charity's exempt purposes, the Service further concluded that the proposed activities would not constitute an unrelated trade or business within the meaning of section 513(a) of the Code, and therefore, would not result in unrelated business taxable income.

Cautionary Note: While this ruling would indicate that a change in a nonprofit's charitable purpose would produce no significant ill effects, charities that are actively engaged in fundraising efforts and receive numerous gifts through devise or bequest should proceed cautiously. Such a change in the organization's charitable purpose could potentially affect the validity of a reversionary clause or conditional bequest or devise. Further, if an organization's public charity status is based upon section 170(b)(1)(A)(6) or section 509(a)(2) of the Code and the organization makes a change to its charitable purpose, it must continue to enjoy, and be able to show, the necessary broad public support required to maintain its exempt status under these Code sections. Otherwise, such an organization would be reclassified as a private foundation.

Court Says Don't Look to Your CRUT to Save Your . . . But It Was a Nice Try!

FSA 200022005. In this field service advice, the Service clarifies that a grantor should not be allowed to invade the corpus of a unitrust for the purpose of satisfying income tax liabilities stemming from his involvement in a tax shelter. After a number of years of participating in the tax shelter, the grantor established a charitable remainder unitrust with shares of appreciated stock. It is more than likely that the transfer of stock to the unitrust rendered the grantor insolvent. And, of course, the unitrust was created just prior to the Service's assessment of a deficiency against the grantor for his participation in the tax shelter. After being served with a notice of tax lien with respect to the tax assessments, the grantor filed a voluntary chapter 7 bankruptcy petition, proposing that the bankruptcy trustee invade the trust corpus to satisfy the claims of the government.

Later that year, the United States filed an action to reduce tax assessments to judgment, set aside fraudulent conveyances, and foreclose federal tax liens. The action alleged that the grantor transferred his stock to the trust with the intent to hinder, delay or defraud the United States of present and future lawful taxes and sought to foreclose on the grantor's interest under the trust. The grantor asserted that he created the trust for the legitimate purpose of avoiding capital gains tax on the sale of his appreciated securities.

Section 664(d)(2)(B) of the Code states that no amount other than the unitrust amount may be paid to, or for the use of, any person other than an organization described in section 170(c). Further, section 1.664-3(a)(4) of the Treasury Regulations says that a trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Because the trust is a separate taxpayer from the grantor, with an independent legal existence, the bankruptcy trustee cannot disregard the trust as an entity and invade an interest which the grantor relinquished upon creation of the trust. A distribution of trust corpus to satisfy the grantor's tax liabilities would also constitute a taxable expenditure as well as an act of self-dealing, not to mention the violation of the vested remainder interest of charity under the trust. For these reasons, only the grantor's interest in the unitrust amount, and not the corpus of the trust itself, should be subject to the bankruptcy estate.

Nonprofit Affiliated With a Governmental Unit May Exclude Income

LR 200019023. The board of directors for a certain town established a nonprofit corporation to issue bonds for the purpose of constructing a new town hall. The arrangement provided that the nonprofit would lease property to the town for its use as a town hall complex. Rents collected from the town would be used entirely to service the debt on the bonds.

Section 115(1) of the Code states that gross income does not include income derived from a public utility or from the exercise of an essential governmental function and accruing to a state or a political subdivision of a state. Revenue Ruling 71-589, 1971-2 C.B. 94, provides that federal income tax does not apply to income from property held in trust by a city to be used for certain charitable purposes. The Service has interpreted the holding in this revenue ruling to include that income which is derived from the exercise of an essential governmental function and accrues to a political subdivision within the meaning of section 115(1) of the Code.

Revenue Procedure 95-48, 1995-2 C.B. 418, provides that

governmental units and affiliates of governmental units that are exempt from federal income tax under section 501(a) of the Code are not required to file annual information returns on Form 990, Return of Organization Exempt From Income Tax. Because only the town benefited from the use of the leased property and the payment of the debt on the bonds, the Service determined that the nonprofit corporation is an "affiliate of a governmental unit" within the meaning of section 4 of Revenue Procedure 95-48. The Service further concluded that, so long as the town is a political subdivision of the state for purposes of section 115(1) of the Code, the nonprofit corporation’s income would be excludable from gross income under section 115(1) and that a federal income tax return would not need to be filed.

Split-Dollar Life Insurance May Be Used to Compensate Nonprofit Executives

LR 200020060. A private foundation has requested a determination from the Service as to whether the use of a split-dollar life insurance arrangement to be entered into by the foundation as part of the compensation package for the foundation’s president would affect its tax-exempt status. A proposed employment agreement provides that, as part of the president’s compensation package, the foundation will maintain term insurance coverage on the life of the president for so long as he is employed by the foundation. The president would be allowed to designate as a beneficiary of the policy the trustee of an irrevocable life insurance trust previously created by the president and his wife. The foundation has proposed entering into a split-dollar life insurance arrangement whereby the foundation will purchase, as owner, an insurance policy on the president’s life. The foundation and the president would share the responsibility for payment of the policy premiums while the president is still in the employ of the foundation. Should the president die while employed by the foundation, the foundation would receive a proportionate amount of the policy proceeds, with the balance of the policy proceeds to be paid to the president’s irrevocable life insurance trust. After seeking input from a private consulting firm, the foundation has satisfied itself that the proposed compensation and benefits package for the president, including the split-dollar life insurance policy, is reasonable as to amount in light of the service that he provides as president and CEO.

Under section 501(c)(3) of the Code, organizations that are operated exclusively for charitable and other enumerated purposes are exempt from federal income tax so long as no part of the organization’s net earnings inure to the benefit of any private shareholder or individual. Additionally, section 1.501(c)(3)-1(c)(2) of the Income Tax Regulations states that an organization will not be considered as operating exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

The Service has consistently held that a tax-exempt organization does not violate the prohibition against private inurement when paying reasonable compensation for services provided to the organization and which are in furtherance of the organization's exempt purposes. Private foundations are held to a higher standard in this regard, having to show that the service rendered was necessary to accomplish the private foundation's charitable purpose. In this letter ruling, the Service determined that providing compensation by paying premiums on a split-dollar life insurance plan is an acceptable form of employee compensation and is not in itself an excessive or otherwise unreasonable compensation arrangement. Accordingly, the Service ruled that the proposed split-dollar insurance arrangement will not jeopardize the foundation's exempt status under section 501(c)(3), nor will the payment of premiums be considered an act of self-dealing under section 4941 or a taxable expenditure under section 4945.

Note: In this ruling, the Service clarifies that the split-dollar life insurance arrangement addressed in this letter ruling is not to be confused with the charitable split-dollar insurance transactions that, until recently, purported to give rise to charitable contribution deductions under section 170 or 2522 of the Code. As discussed in the April 2000 issue of Charitable Gift Planning News, the Ticket to Work and Work Incentives Improvement Act of 1999 added section 170(f)(10) to the Code, prohibiting charitable deductions for transfers arising out of split-dollar insurance arrangements.

CLT Retaining Interest in Limited Partnership is Not Self Dealing

LR 200018062. A grantor established a charitable lead unitrust and provided that a portion of the residuary of his estate be contributed to the trust. The residuary estate which passed to the trust included a limited partnership interest. The sole purpose of this limited partnership is to provide professional investment management and advisory services on a cost-effective basis to members of the grantor's family.

The limited partnership's general partner (the "general partner") is a corporate entity which was also created by the grantor along with his children. Currently, descendant's of the grantor own approximately 60% of the voting power of the corporate general partner. The sole purpose of this corporation is to serve as the general partner for the limited partnership and is specifically precluded under the limited partnership agreement from engaging in any other form of business.

The grantor's children also own 44.7% of yet another company (the "company") which provides accounting, tax and clerical services to both the charitable lead trust and the limited partnership. The charitable lead trust pays the company for the aforementioned services it performs on behalf of the trust and also

pays the limited partnership for investment management and advisory services that it provides to the trust. The Service was asked by the trustee of the charitable lead trust to rule with respect to the possible federal tax consequences to the trust resulting from these transactions.

Section 4941(d)(1)(E) of the Code defines "self dealing" as any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. The limited partnership is a disqualified person with respect to the charitable lead trust pursuant to section 4946(a)(1)(F) of the Code because family members of the grantor (also disqualified persons pursuant to section 4946(a)(1)(B) and (D)) own over 35% of the profits interest. The general partner and the company are also disqualified persons with respect to the trust pursuant to section 4946(a)(1)(E) of the Code because, again, family members of the grantor hold in excess of 35% of the combined voting power. Although the limited partnership, its general partner and the company are all disqualified persons under section 4946, the Service concluded that co-investments by the charitable lead trust and such disqualified persons does not constitute a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the charitable lead trust under section 4941(d)(1)(E).

Payments or reimbursements made by a private foundation to a disqualified person generally constitute an act of self-dealing under Code section 4941(d)(1)(D). However, Code Section 4941(d)(2)(E) provides an exception from self-dealing for payment of compensation or reimbursement of expenses by a private foundation to a disqualified person for "personal services" that are reasonable and necessary to carry out the exempt purpose of the private foundation if the compensation or reimbursement is not excessive. Here, the Service determined that the personal services rendered to the charitable lead trust by the limited partnership and the company were reasonable and necessary for the trust to carry out its charitable purpose of distributing funds to tax-exempt organizations.

Reformation of CRUT Preserves Status and Saves Contribution Deduction

LR 200022014. Prior to the implementation of the ten percent rule for charitable remainder trusts, a grantor executed and funded a charitable remainder unitrust which pays income to him for his lifetime (at a 5% payout rate) and then will provide income to several other individual beneficiaries for their joint lives. The grantor recently made an additional contribution of property to the trust, only to realize after the fact that the additional contribution did not comply with the new ten percent rule under section 664(d)(2)(D). The trustee petitioned a state court to sever the amount representing the additional contribution from the trust and transfer

the severed amount into four separate trusts. The terms of the four new trusts would be identical to those of the original trust except that each new trust would only name one successor income beneficiary. By severing and establishing the new trusts, the trustee represented that the new trusts and the original trust would comply with section 664(d)(2)(D). The state court granted the petition conditioned upon receipt of a favorable private letter ruling.

The Taxpayer Relief Act of 1997 added several new sections to the Code which apply to this situation. Of course, section 664(d)(2)(D) requires that for each contribution of property to the trust, the value of the charitable remainder interest in the property must be at least ten percent of the net fair market value of the property as of the date of gift. Section 664(d)(4) provides that, for any contribution made to a trust that would result in the trust ceasing to be a CRUT by reason of section 664(d)(2)(D), the contribution shall be treated as a transfer to a separate trust under regulations prescribed by the Secretary. At this time, there are no regulations under section 664(d)(4). Finally, section 2055(e)(3)(J)(ii) allows a trust which does not meet the requirements of section 664(d)(2)(D) to be reformed by reducing the payout rate or duration (or both) of any noncharitable beneficiary's interest to the extent necessary to satisfy such requirement.

Applying the applicable law, the Service concluded that the amount representing the additional contribution could properly be treated as a transfer to a separate trust that may be reformed pursuant to section 2055(e)(3)(J)(ii). Because the four new trusts will each name only one successor unitrust beneficiary, the duration of the noncharitable beneficiaries interests will be sufficiently reduced to comply with section 664(d)(2)(D). Accordingly, the four new trusts, as reformed, will be considered qualified CRUTs, and the amount of the additional contribution will be deductible under section 170. Further, neither the additional contribution nor the reformation will affect the qualified status of the original CRUT.

Private Foundation May Accept Conditional Transfer of Assets

LR 200019044. A decedent created a living trust during her lifetime. Through her will, she established a private foundation under section 509(a) of the Code. The decedent died in 1993. To wind up the affairs of the living trust, all remaining assets are to be distributed to the private foundation pursuant to the terms of the decedent's will. Under applicable state law, a distributee of such a trust can be required to return amounts distributed to it to the extent that claims arise against the trust or against the estate or the decedent from which the trust acquired its property. Accordingly, the trustees of the private foundation and the living trust entered into an agreement whereby the private foundation will receive the property subject to a condition that the foundation return any

portion of the assets, including back taxes, to any valid claimant against the trust for whom there would be a statutory lien on the assets by operation of the state probate law. The Service was asked to rule on whether an act of self-dealing or a taxable expenditure would arise should the foundation make a refund pursuant to the agreement or state law.

Section 4941(d)(1)(E) of the Code provides that an act of self-dealing includes a transfer to, or use by, a disqualified person of any assets of a private foundation. Section 4941(d)(2)(A) states that the transfer of property by a disqualified person to a private foundation will be an act of self-dealing if the private foundation takes the property subject to a mortgage or similar lien placed on the property by the disqualified person. The Service concluded that the agreement between the trust and the foundation does not constitute a "mortgage or similar lien" on the property within the meaning of section 4941(d)(2)(A) of the Code. While the condition under the agreement constitutes a "lien" on the property in the ordinary sense of the term, the term "mortgage or similar lien" generally implies a voluntary act of the disqualified person in placing the lien on the property, whereas this equitable lien arises as an operation of law. Therefore, the agreement, and any refund under it, will not involve a "transfer to, or use by of for the benefit of, a disqualified person of the income or assets" of the private foundation.

Further, section 4945(d)(5) of the Code provides that a taxable expenditure includes any amount expended by a private foundation for purposes other than those under section 170(c)(2)(B) of the Code, which includes charitable and other exempt purposes. In this situation, the Service concluded that any refunded assets under the agreement will not be expenditures for noncharitable purposes under section 4945, but rather, will constitute necessary administrative expenses.

How to Succeed with Today's New Breed of High-tech Philanthropists

If you're involved in charitable gift planning and fund-raising today, you need to know about the current breed of younger ultra-rich donors we hear so much about these days. This month's Planners' Forum helps us know what to expect and what approaches to follow with this group. This piece is reprinted from AHP Connect, with the permission of its publisher, the Association for Healthcare Philanthropy. It is written with the healthcare institution in mind, but it doesn't take much imagination to translate it for other types of institutions.

Philanthropy has a new face these days. It's bright, fresh, 30-something, and awash in millions made in the high-tech industry. Who are these new millionaires? What are their

interests? More importantly, how you get their attention?

AHP interviewed four fund development professionals across the country to explore these questions and assess the potential of this new group of high-tech philanthropists.

Understanding the demographic profile of this emerging group is the best place to start. "They are young, dynamic, work 60 to 70 hours a week, and never dreamed they would get rich so quickly," says Milton J. Smith, president of the John Muir Medical Center Foundation in Walnut Creek CA. "They are just beginning to think about what to do with their money. They are giving to health care, but, as yet, not at high levels."

Echoing Smith's sentiments, Suzanne Ryan Curran Dalston, vice president of gift development at Northwestern Memorial Foundation in Chicago, says, "In this group, most have no experience with philanthropy. It's an opportunity. Our challenge is to get them interested."

Steve Meyerson, vice president for development at INOVA Health Systems Foundation in technology-rich Northern Virginia, notes that many of these potential donors "haven't even started their families. With the usage of our services, they will grow to appreciate the need to support the health care infrastructure."

The relatively young age of these new millionaires, ranging from the late 20s to the mid 40s, presents special issues for fund-raising professionals. "They may not have had a health crisis," Smith says, "so they don't have ties to a health care facility. They feel personal about the money they've earned. At 30 or 35, health care may not be a pressing personal issue."

Meyerson concurs, adding, "They are starting to appear on the donor list of moderate-to-medium size gifts. But big gifts won't come until they get involved with the lifeblood of the institution."

At the Palo Alto Medical Foundation in the heart of Silicon Valley, Kathleen Boice, director of annual giving, stresses the importance of "being cognizant of the difference in culture between this group and the health care hierarchy. They're not interested in influence or prestige — no long lunches or endless meetings. They're focused on convenient services or on a specific project."

But, according to both Smith and Dalston, these potential donors will show up for special events — if the right person asks them. There is one trait they share with the more traditional donors, says

Dalston. "They respond best to their peers. This means you have to work diligently with your board to identify potential donors among their colleagues, family, and friends."

To better understand this sometimes elusive group, Meyerson describes two main types: Those who want to be actively involved in the charity they support; and, those who want to support a good cause but are not interested or too busy to take an active role.

For the hands-on donor, INOVA recently created a special fund that allows donors to be deeply involved and recommend how funds are to be used. For the ultra-busy donor, Meyerson urges fund-raisers to "make a crisp, efficient case for support. Explain the need, how their gift will be used; and give feedback on the outcome. That’s all they want."

To accommodate the needs of the overscheduled high-tech executive, Palo Alto Medical Foundation developed a patient appreciation program as a way to thank its Silicon Valley contributors. "We offer to coordinate medical appointments in sequence to take care of their needs more efficiently," explains Boice. "For example, an executive preparing to travel to Japan can have a check-up and inoculations all in one visit. If there is any lag time, our executive lounge offers e-mail and fax capabilities."

Fund-raisers approaching this dynamic new group may quickly discover what doesn’t interest them: Long committee meetings, awards events, snail mail, dress-up dinners, and personal solicitation visits, to name a few.

According to Meyerson, what does interest them is the interaction of technology and medicine. "There are many ways for information technology and medicine to connect, such as telemedicine programs and technology-driven research," he says. Smith adds, "This type of donor is more interested in finding a cure for cancer than in supporting a cancer treatment program. Using today’s technology to provide better medicine is the secret to gaining their interest."

However, Boice cautions that it’s not wise to generalize about these high-tech millionaires. "Their giving philosophy is just developing, and it’s not what we’re used to," she says. "Individuals have individualized preferences. They give when they are interested, and they need a longer cultivation period."

How do you get their attention? All sources agree on the best ways to target this new group:

n Get comfortable with using e-mail;

n Upgrade your web site technology, and make sure it works;

n Develop innovative web site features (offer better links, more information, perhaps the convenience of handling pre-hospitalization paperwork on-line);

n Devote a full web page to philanthropy issues;

n Be prepared to accept gifts of stock from this cash-poor but stock-rich group;

n Develop programs that focus on prototypes for the future of high-tech medicine;

n Think differently (instead of the usual black-tie affair, plan a sailboat race);

n Cultivate long-term partnerships between corporate philanthropy and your health care institution;

n Whenever possible, recruit potential donors or their families to join the board; and,

n Network and be patient. Remember, this exciting group of donors is still in an embryonic stage.

Gift Timing - What If the Gift Is Sent Via FedEx?

And now, something for all you readers who love legal analysis with an ambiguous outcome — a technical gift planning issue you probably never considered.

We all know the basic rules on gifts sent by mail. But when does this rule apply? If the gift absolutely, positively has to be there overnight, the donor is quite likely to send it by a courier service. Experience suggests this is probably the best way to get a package to the addressee quickly, but is it as effective for tax purposes? The question is a straightforward one — when is a contribution deemed "made" for tax purposes if the donor sends the gift property to the donee via a private courier, such as Federal Express, rather than the U.S. Postal Service. As we shall see, this simple question does not have a straightforward answer.

The Regulations, in Treas. Reg. §1.170-1(b) provide as follows:

> "In the case of a check, the unconditional delivery (or mailing) of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery (or mailing). If a taxpayer unconditionally delivers (or mails) a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery (or mailing, provided that such certificate is received in the ordinary course of the mails). "

The repeated use of the terms "mailing" and "mails"in this regulation has given rise to the generally accepted impression that the date of mailing is the date of contribution. Thus, at least in the case of a donor who uses the U.S. Postal Service, our answer is clear.

Unfortunately, the answer in the case of the FedEx customer is open to several interpretations. On the one hand, the overall principle would seem to be that a donor parts with dominion and control over the gift when he or she delivers it into the delivery system that will take it to the donee, and the gift is complete at that time. On the other hand, the Regulation quoted above, by using the term "mail," doesn't necessarily address the overall principle.

It may be the case (and we have not investigated this) that FedEx provides its customers with some sort of opportunity to retrieve a package prior to its delivery. The existence of a tracking system suggests that this may be true (although the Postal Service likewise offers a tracking system for some classes of mail). If this is true, and the Postal Service does not permit such an opportunity to retrieve shipments, there may be some justification for limiting the Regulation to the U.S. Mail.

Even this is not entirely clear, however, since a donor who sends a check by U.S. Mail has the opportunity to stop payment on the check, thereby preventing payment to the donee; under the Regulation itself, failure of the check to clear in due course

overrides the date-of-mailing rule. Although the Regulation is silent on the point, it seems likely that the donor who mails a stock certificate could somehow thwart reregistration of the stock by the donee by notifying the issuing corporation or the transfer agent; if that should occur, certainly the donor's deduction would be denied (or at least delayed) notwithstanding the Regulation.

Absent such a factual basis for distinguishing between private carriers and the Postal Service, there are reasons why such a distinction may be inappropriate. The parallels are obvious. In both cases the donor has sent the package on its way and it will be delivered in due course. If this does not occur for any reason (or if the check fails to clear), the deduction can just as easily be denied or delayed for the FedEx customer as for the U.S. Postal Service customer. Indeed the use of the term "mails," with a lower case "m," leaves open the argument that the use of a private mail service such as FedEx should also be included. It is worth noting that this rule has been in the Regulations since well before the availability of such private mail services. At one time there were strict prohibitions on such incursions on the official monopoly then enjoyed by the Post Office. All of these considerations make it obvious that the use of the term "mail" in the Regulation was conceived in a different climate, and was perhaps inevitable at that time.

Another point that may be significant is that the Internal Revenue Code provides a parallel rule in another context (section 7502, entitled " Timely Mailing Treated As Timely Filing And Paying"). That provision was amended in 1986 to provide that private delivery services could be used without losing the benefits afforded use of the Postal Service. In this instance, FedEx is deemed to be the equivalent of the United States mail. However, that provision applies only to items sent to the Internal Revenue Service; it has no application to charitable contributions.

All of that, however, goes more to what the rule should be than to what it actually is. In an effort to see how the tax agency views this issue, your editors called a friend who works in the Exempt Organizations of the Internal Revenue Service National Office, there to raise the question, and he in turn called a person in the Income Tax unit that actually has responsibility for this Regulation. Surprisingly, those people had no clear answer and simply stated that in their view the FedEx situation is not covered by the Regulation. Section 7502 may be read as suggesting Congress would not distinguish between FedEx and the U.S. mail for contribution purposes if it should consider that question. On the other hand, the failure of Congress to address that issue when it amended section 7520 can also be read as underscoring an intention to extend the mail analogy this far and no farther.

So that is the current state of the law — there is no definitive answer. Our contact at IRS suggested that, in his view, the IRS would not seek to use the strict wording of the Regulation to deny a claimed charitable contribution deduction, but that is merely his opinion (although we agree with his assessment). The only way to

get a clarification would be to pose the question in a request for a private letter ruling. That is an expensive solution, and would require an actual donor with the issue; the Internal Revenue Service doesn't respond to hypothetical questions, even important ones such as this.

The donee receiving a charitable gift would generally be a neutral party on this issue, for there is no uniformly favorable or unfavorable result. The date on which a contribution is "made" has two immediate consequences. It determines the taxable year in which the donor's deduction will be allowed, and it also determines the amount of that deduction for stock gifts and other contributions of property for which values fluctuate. Thus, some donors might profit from the current ambiguity, allowing them to select the date which produces a higher gift value, while others might suffer as their deductions are delayed into a subsequent taxable year. Accordingly, creation of an internal policy for handling such contributions may produce negative results for some donors despite the apparent advantage of having a uniform rule.

As with so many situations, the tax law is simply unclear on this point. As a result, donors must arrange to protect themselves to the extent they can do so. For year-end gifts, they would be well-advised to send their gifts via the U.S. Postal Service if they want the certainty of knowing that the gift is made when sent to the donee. The same would be true of property gifts which are fluctuating in value. While private couriers may offer assurance of prompt delivery, this is unnecessary and costly in comparison to the Postal Service, at least until the Internal Revenue Service moves to clarify the law. Until then, all donors should be advised to "Fly Like an Eagle" (the official advertising jingle of the U.S. Postal Service) if certainty is more important than the result.

Are NIMCRUT Reformations Possible After June 30?

By now most gift planners have completed (or at least commenced) the reformations needed to change the net income charitable remainder unitrusts (or "NIMCRUTs") entrusted to them into the new "flip" unitrust format approved by IRS in the 1998 regulations on this subject. Those regulations originally set a deadline of June 8, 1999, for such reformations of NIMCRUTs created before December 10, 1998, and the IRS later extended this to June 30, 2000. Well, now that June 30 has come and gone, it is too late for such reformation actions to be started, isn't it?

Yes, in most cases, since a deadline is a deadline and this one has now passed. Nevertheless, in some admittedly rare cases, it may still be possible for a NIMCRUT to be reformed into a flip unitrust. The IRS Procedural Regulations include a set of

provisions permitting extensions of time for making various tax elections and other relief where the time in question is prescribed by the IRS in a Regulation or other IRS document and NOT by the Internal Revenue Code. Some of these times are automatically extended, such as the time for filing an exemption application, which is set at 15 months from the date the organization in question is filed, but automatically extended by another year, to 27 months. No special processing is needed; the IRS simply will treat the filing or other act as timely if it is made within the extended time.

For other items, however, the IRS will consider on a case-by-case basis whether to grant relief for an untimely act. The provision in question here is Regulations Section 301.9100-3, which provides that relief may be granted when taxpayers provide evidence to establish that they acted reasonably and in good faith, and that the granting of relief will not prejudice the interests of the government. The procedure is essentially the same as that for a private letter ruling, and calls for detailed affidavits establishing the facts relied upon and payment of a user fee that can be quite substantial.

Will this provision be applied to permit a pre-December10, 1998 NIMCRUT to be reformed into a flip unitrust even though the necessary court action is commenced after the general deadline of June 30, 2000? Although there is no definitive answer, some IRS officials have agreed informally that this may be the case, although no decision has been made on this issue. Although this sort of extension (called "9100 relief" by tax lawyers) is most commonly granted for tax filings of various sorts, the reformation deadline does meet the basic standard in that the June 30 deadline was imposed by the IRS and not in the Internal Revenue Code. The deadline was already extended in IRS Notice 99-31, 1999-23 IRB 6, and extension in appropriate cases would seem to be in keeping with the purpose of Regulations Section 301.9100-3 (and the evolving culture of our new, kinder and gentler IRS).

The other requirement, that the interests of the government not be prejudiced, would probably be met in most reformation situations. The applicable standard under the regulation has been whether relief would result in a taxpayer having a lower overall tax liability (for all years to which the relief would apply) than he or she would otherwise have had. Since the change involved in a trust reformation is prospective, it would be difficult to say that the interests of the government are prejudiced by this change.

This is not to say that this provision could be used to permit the reformation of just any trust that missed the deadline. A taxpayer must demonstrate to the satisfaction of IRS that he or she has acted reasonably and in good faith in missing the deadline and seeking an extension. That would require more than a showing that the taxpayer forgot, was very busy, or meant to get started but got distracted. A person who was notified of the June 30

deadline by the trustee, or an accountant or lawyer, would be hard pressed to show why he or she deserves another chance. Similarly, one who merely failed to make the decision in time or otherwise lacks a good excuse may have trouble qualifying. On the other hand, a person who was not notified, or who received poor advice might be able to justify an extension. The final decision on this is in the discretion of IRS, and no guidance has been offered as yet on the point.

Thus, while the outcome is not certain, it would seem to be worthwhile for trustees and beneficiaries of some NIMCRUTs to consider requesting 9100 relief for a post-June 30 reformation. Watch for further developments on this score.

IRS To Revise Sample CRT Forms

IRS Notice 2000-37, 2000-29 IRB 118 (7/71/00). Now that its old sample CRT forms are getting a bit out-of-date, the IRS is ready to revise them and they would like your help!

The IRS has tried several approaches to this project over the years. In 1972, they issued a comprehensive guide in Rev. Rul. 72-395, listing mandatory provisions and options, with explanations of each. This was updated in 1980, 1982, and 1988. Then, in 1989 and 1990, IRS issued a series of Revenue Procedures (Rev. Procs. 89-20. 89-21, 90-30, 90-31,and 90-32) providing complete sample forms of various types. Since then, there have been changes in both the Internal Revenue Code and the Regulations, including the introduction of an entirely new form of unitrust, the Flip trust.

In this notice, the IRS has advised that it intends to revise the forms to reflect these changes, and invites comments from the interested public on what revisions are in order and what format the new forms should take (i.e., complete sample forms, as in the 1989 and 1990 Revenue Procedures, or generic forms with optional provisions for various situations). Written comments may be mailed to:

Internal Revenue Service

Attn: CC:DOM:CORP:R (Notice 2000-37, Room 5226)

PO Box 7604

Ben Franklin Station

Washington, DC 20044

Alternatively, comments may be submitted electronically to:

sharon.y.horn@M1.IRSCounsel.treas.gov

All comments and suggestions will be made available to the public, and they should be submitted by December 1, 2000.

Is IRS Taking Closer Look at Supporting Organizations?

Increasingly, we see articles and seminar presentations that describe the restrictions that affect private foundations and outline alternatives that avoid those restrictions. One of those alternatives most frequently mentioned is the supporting organization described in section 509(a)(3) of the Internal Revenue Code. Often the supporting organization is touted as a device that is freely available to anyone seeking the benefits of private foundation without the attendant disadvantages. There are two important caveats in this area that should not be overlooked by an enthusiastic or exuberant advisor or donor. One is a set of significant recent developments and the other is a sometimes-overlooked provision of the Internal Revenue Code itself.

> *[Caution - Extreme technical detail ahead. Don't say you were not warned!]*

Background

Remember that the supporting organization is excused from the private foundation category because of its close relationship with one or more public charities. The latter are called its "supported organizations" or its "beneficiary organizations." People considering the supporting organization as an alternative to a private foundation are often interested in the so-called "Type 3" supporting organization, which is "operated in connection with" the public charity or charities it supports. This is the most attenuated of the permissible relationships, so the requirements are more complicated than those governing the alternative relationships, in which the supporting organization is "operated, supervised or controlled by" or "supervised or controlled in connection with" its beneficiary organizations. These latter categories are often rejected by donors or advisers on grounds they give too much control to the beneficiary organization(s).

To qualify as "operated in connection with" a public charity, the supporting organization must meet several highly detailed tests, including an "integral part" test. This test is designed to assure that the supporting organization maintains a significant involvement in the operations of one or more of its beneficiary organizations and the beneficiary organizations are in turn dependent upon the supporting organization for the type of support which it provides.

Under the Regulations, there are two alternative means by which the integral part test may be met. Either (1) the supporting organization engages in activities that perform the functions of or carry out the purposes of the supported organizations and, "but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves," or (2) the supporting organization pays substantially all (at least 85%) of its income to or for the use of the supported organizations and the amount received by them is sufficient to insure their attentiveness to the operations of the supporting organization.

In general, under Alternative (2) the amount of support received by a supported (beneficiary) organization must represent a sufficient part of its total support so as to insure such attentiveness. Alternatively, even where the support received does not represent a sufficient part of the beneficiary organization's total support, the amount received from a supported organization may nevertheless meet the attentiveness requirement if it can be demonstrated that in order to avoid the interruption of a particular function or activity, the beneficiary organization(s) will be sufficiently attentive to the operations of the supporting organization grants (e.g., where the support in question is earmarked for a substantial program or activity of the beneficiary, even if it is not the beneficiary organization's primary program or activity).

Recent IRS Action

In several recently-released exemption letters, the Internal Revenue Service has rejected exemption applications in which the organizations in question sought supporting organization status as Type 3 supporting organizations "operated in connection with" their beneficiary organizations. These are the letters issued to two Utah trusts, Edelweiss Foundation (Tax Analysts Doc. No. 2000-11766) and Pearce Family Foundation Tax Analysts Doc. No. 2000-11773). Each organization was required to distribute thirty percent of its net income to Ensign Peak Foundation, an organization devoted to preservation of sites with historic significance to the Church of Jesus Christ of Latter-Day Saints, and another 55 percent was to be distributed among a number of other public charities designated in a schedule attached to the trust instrument; one trust listed more than 80 such other organizations and the other listed more than 100.

In each case, the IRS found that the organization failed the

attentiveness requirement because the amount of support provided to the beneficiary organization was insufficient to assure its attentive this to the supporting organization. The annual amounts in question, which varied from $2,010 to $8,158, did not represent a sufficient part of the total budget of the supported organization. In addition, although each organization provided a major portion (85 to 95 percent) of the support for a particular function or activity, in each case the IRS concluded that the project was not a substantial program of the supported organization "since the funds expended on it constitute less than one percent of the [supported organization's] total income" for the year in question.

"Control" Test

In addition, anyone considering the choice between the supporting organization and private foundation should be aware of one very important distinction between these categories. A major advantage of the private foundation is the founder's ability to exercise absolute control over the foundation and its grants. This is the determining factor for many people and families facing this choice.

The supporting organization is sometimes portrayed in general terms as offering a similar degree of influence, that is short of actual control but may nevertheless be an acceptable alternative. What may be overlooked is that the Internal Revenue Code definition of the supporting organization (in section 509(a)(3)(C)) includes a requirement that it "is not controlled directly or indirectly by one or more disqualified persons." The Regulations, in Sec 1.509(a)—4(j)(1), indicate that if two of the five trustees of a supporting organization are disqualified persons, the organization will not be considered controlled by them by reason of this fact alone. However, the regulation goes on to say —

> "However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization."

Thus, the overall circumstances may be reviewed to determine whether disqualified persons really exercise control of a supporting organization, regardless of the outward appearances. As a result, the sort of clever arrangements that may make a particular structure acceptable to a donor may be dangerous. Sometimes we tend to forget that the IRS wasn't born yesterday.

Implications for Planners

The Internal Revenue Service has not always been consistent in its administration of the complex rules governing supporting organizations. The regulations that spell out the requirements for qualification as a Type 3 supporting organization are necessarily vague, as the standard they seek to define is itself unclear. In the past, planners have sometimes used techniques that push the limits. One approach has been to designate a large number of "supported" beneficiary organizations, then sprinkling the would-be supporting organization's grants among them in exactly the manner of a private foundation. Another is to use a donor-advised fund in a community foundation or elsewhere as the supported beneficiary, then allow the donor to "advise" where the ultimate distributions will go. These techniques and others may be in for closer examination in the future.

There are some indications that the donor-advised fund legislative proposals now pending in Congress may eventually be expanded to include some new statutory rules for supporting organizations. The legislative background for those proposals demonstrates that the legislative staffs view these two areas (supporting organizations and donor-advised funds) as related — both offer donors a ready means of avoiding the restrictions applicable to private foundations. Fashioning a solution to one thus invites attention to the other as well.

Corporate Sponsorship Hearings Center on Exclusivity Deals

The IRS held a hearing June 21 on its proposed corporate sponsorship regulations, and most attendees suggested that revisions were needed in the portion of the proposed regulations dealing with exclusive provider arrangements.

For some time, controversies have arisen in distinguishing between when payments to charity by a corporate sponsor will be treated as a contribution (not taxable to the recipient) and when they will be taxable advertising payments. In 1997, Congress stepped in to provide that "qualified sponsorship payments," those that bring the payor no benefits other that the use or acknowledgment of its name, logo or product lines, will not be taxable. But the proposed regulations drew a distinction between such arrangements and exclusive provider arrangements which call for the recipient organization to exclude products of the payors' competitors. The typical example is that of a college that, in return for a payment from Coca Cola agrees that Pepsi Cola will not be sold on campus. Although reaction to the regulations was generally favorable, many witnesses at the hearing criticized the provisions treating exclusive provider arrangements as necessarily conveying a

substantial return benefit (thus making the provider's payments taxable).

CRT Amendment - Donor Makes the Rules, Must Follow Them

PNC Bank, NA, Trustee v. Camping and Education Foundation, et al., Court of Appeals, 1st Appellate District (Hamilton County, Ohio). John Holden created a charitable remainder unitrust in 1976, retaining the right to change the charitable beneficiaries. Under the trust instrument, any such change was to be made via a written instrument signed before two witnesses and notarized. By the time of his death in 1998, Mr. Holden had amended the trust on four separate occasions. The first amendment was done as prescribed in the trust instrument, with two witnesses and a notary, but the last three were not notarized.

The court held that only the first amendment was effective, and dismissed the claims of the organizations named in the other three amendments. Attempted amendments that are not made in compliance with the express terms of the trust instrument are ineffective, the court found. While the nonconforming amendments might be viewed as reflecting the intention of the donor, the court found that it was precluded from examining such evidence because such "extrinsic evidence" is examined only where there is some uncertainty as to the intent of the donor. Here, the donor had set forth clearly just how a change of beneficiary was to be accomplished, and that intention was controlling.

Injunction Upheld Against Charitable Promoters

United States v. Estate Preservation Services, 202 F. 3rd 1093 (1/25/00). Robert Henkell and William Sefton set up Estate Preservation Services ("EPS") in 1992 to market various trusts and other asset protection devices. When the IRS learned of their activities in 1995 upon auditing several EPS clients, it characterized their trusts as tax shelters designed to produce excessive and/or improper deductions, and imposed substantial penalties. Thereupon, Messrs. Henkell and Sefton changed their approach and created New Dynamics Foundation ("NDF"), which offered donor-directed foundations to their customers.

NDF customers were told that they could establish charitable foundations through NDF solely for their own benefit, providing employment to donors and their families, and assuring "continued income during the retirement years." All a donor had to do to

access his or her "warehoused" wealth was to submit a so-called expenditure "request." Moreover, it appeared that only one of these "requests" was ever rejected and the "charitable use" of the disbursed funds was never verified.

On these facts, the Ninth Circuit upheld the lower court judgment granting the government an injunction against the further promotion of these tax shelters. Messrs. Henkell and Sefton were well-educated and both knew or had reason to know that the tax consequences they were promoting were false.

Cases such as this show why some people (within the IRS and elsewhere) may look askance at unfamiliar charitable offerings, particularly when they are promoted as a means of accomplishing personal, noncharitable goals. This scheme was not even remotely charitable, and its demise was both predictable and justified.

What If a Charitable Trust Runs Out of Beneficiaries?

State ex rel Lee v. Montgomery, Ohio Supreme Court (2/22/00). In his will, executed in 1988, Walter Havighurst created a trust "for building cross—cultural understanding between the peoples of United States of America and the Union of Soviet Socialist Republics." Within guidelines, the trust authorized the president of Miami University to determine the nature of such projects and the amounts to be disbursed. By the time Mr. Havighurst died in 1994, the Soviet Union had dissolved, and his heirs went to court contending that the charitable trust had thus failed. The probate court, the court of appeals, and the Ohio Supreme Court all rejected this position, and the U.S. Supreme Court declined to hear the case.

In this action, the attorney who had unsuccessfully represented the heirs during these proceedings tried a new tack— she sought a writ of mandamus to compel the State Attorney General to take whatever action would be necessary to identify the class of beneficiaries of the charitable trust. The Ohio Supreme Court rejected this new approach, viewing it as "a thinly veiled attempted to overturn a probate court judgment that she failed to reverse on appeal when she represented the heirs."

The court noted that, not only is a charitable trust permitted by law to have vague, undefined and uncertain beneficiaries, but it is *required* to have such beneficiaries, and the very essence of the charitable trust lies in the indefiniteness of the charitable trust beneficiaries. As the courts in the earlier proceeding had held, the references in the trust to the "Union of Soviet Socialist Republics"

were construed to mean the "former Union of Soviet Socialist Republics," and the charitable trust was upheld.

Ho Hum, Another Reformation Approved

LR200024014. A decedent's revocable trust created a nonqualifying charitable trust allowing an individual to occupy trust real estate for life and providing discretionary distributions for maintenance of the real estate and, after the death of that individual, for two designated charities. The IRS approved a reformation of the trust to create two separate trusts. One is wholly charitable trust for the benefit of the two named charities. The other is a charitable remainder annuity trust providing monthly distributions to the named individual for life, which he or she could use for rent and upkeep of the real estate in question. Upon his or her death, the trust assets will pass to the wholly charitable trust.

It is sometimes hard to believe that such complicated restructuring is still needed today, over thirty years after the creation of our charitable remainder trust rules. It seems obvious that proper planning and drafting at the outset would have made this reformation (and ruling) unnecessary.

IRS Finally Flexes Its Intermediate Sanctions Muscles

The IRS showed serious resolve when it imposed intermediate sanctions on Sta-Home Health Agency in October 1999, imposing first-tier and second-tier excise taxes and revoking its exemption. Sta-Home Health Agency is a group of agencies formed in 1979 to provide health care to homebound patients in Mississippi. Exempt under 501(c)(3), Sta-Home attempted to convert to for-profit status, transferring its assets to S-corporations owned by the company's founders and their children. The S-corporations simply assumed Sta-Home's liabilities after its accountant established a negative valuation.

The IRS valued each of the agencies at over $5 million (which, if accurate, means the accountant grossly undervalued the agencies) and determined that excess benefit transactions had occurred. The IRS found that Sta-Home's directors and it corporate successors – the disqualified persons – were liable for first-tier and second-tier excise taxes (reportedly in the neighborhood of $83 million). The IRS also retroactively revoked Sta-Home's exempt status for transferring is assets for less than adequate consideration. Sta-Home has initiated a challenge to the intermediate sanctions and revocation in Tax Court.

IRS Issues Final Regulations on Private Foundation Disclosure Requirements

The IRS issued final regulations on private foundation disclosure requirements on January 12, 2000 that essentially codify the proposed regulations, extending the section 6104(d) disclosure requirements applicable to other types of tax-exempt organizations to private foundations as well. There were only minor changes. The IRS did not adopt any significant recommendations submitted by commenters.

The final regulations clarify that "annual information return" includes those returns required to be filed under Section 6033. This means that, in addition to copies of their applications and their three most recent information returns, private foundations must disclose their Forms 990-PF and 4720. And, unlike other exempt organizations, they are also required to disclose the names and addresses of their contributors. Additionally, for purposes of section 6104(d), "tax-exempt organization" and "private foundation" include nonexempt private foundations and non-exempt charitable trusts described under section 4947(a)(1) that are subject to the section 6033 information reporting requirements.

One caveat is that the disclosure rules will only apply to Forms 990-PF that were filed on or after March 13, 2000, the effective date of the regulations. Therefore, some foundations will not be subject to disclosure of Form 990-PF until 2001.

Section 527 Disclosure Bill Passed

On July 1, 2000, President Clinton signed a bill requiring disclosure by section 527 political organizations. The legislation does not extend disclosure requirements to section 501(c) organizations, allowing, at least for now, civic leagues, labor unions, and trade associations to continue to conduct undisclosed political lobbying activities. But Republicans had hoped the bill would reach these groups as well, so future expansion of those groups affected by the disclosure requirements is possible. The bill requires section 527 organizations to issue reports on donor lists and accountings of how political groups have spent funds to the IRS. In election years, the reports are required every three months as well as twelve days before and thirty days after an election; they are required less often in non-election years. The reports must disclose the name, address, and occupation of persons receiving expenditures of $500 or more from the political organization or contributing $200 or more to it.

IRS Issues Election-Year Warning to Charities

The Service issued a Notice reminding charities that their efforts to educate voters during elections must stay within IRS guidelines. Activities forbidden of section 501(c)(3) organizations include endorsing candidates, contributing money to campaigns, engaging in fund-raising, distributing statements, and engaging in any other activities that me help or harm any candidate. Possible consequences could be excise taxes on money spent on prohibited activity or even loss of exempt status.

Internet Fundraising Issues

A variety of internet sites allowing gifts to charity have popped up in recent years. While some only allow contributions to select charities, others allow the donor to contribute to any charity granted such status by the IRS. Myriad issues arise, however, when taking a closer look at some of these practices.

Charitable gifts made to charities running their own sites will generally be deductible. But those made to for-profit agency sites may be a different story. Some of the sites charge up to a fifteen percent commission on gifts made through the site. While charities are generally allowed to hire fund raisers, and some charities have done just that by entering into contracts with these online agents, not every site has a contract with the charities that can receive gifts through it. In fact, many of the sites have simply obtained information on their included charities from the IRS and have no actual affiliation with the charity. In this instance, hefty commissions and the lack of a formal business relationship may reduce the deductibility of the charitable gift.

Another hurdle arises in the jurisdictional issues attached to the internet. The site may effectively be soliciting contributions worldwide. Many states require not only standard business registration but also registration as a commercial charitable solicitor with the state before an agency may solicit funds there. This may require disclosure of contracts, if they exist, amounts raised, and fees charged, among other things. Additionally, most states require the continuing bonding of commercial charitable solicitors. The administrative expenses of such ventures may make them impracticable unless they continue to charge hefty fees. Of course, it is those hefty fees that may cause deductibility problems, causing a further difficulty for the efficacy of a particular site. Additionally, claims of contributors may subject the agency to litigation in a foreign jurisdiction.

Some sites add the complexity of offering something of value in exchange for the donor’s contribution. This, of course, places the

burden on the donor to demonstrate that there was indeed a gift to the charity above and beyond the value of the item received in return for the donor's contribution, adding an additional level of complexity to the scenario.

Various Gifts State Compliance Under Blue Sky Laws

When Congress adopted the Philanthropy Protection Act of 1995 (the "PPA") it preempted state law unless a state opted out of preemption. In effect the PPA gives an exempt transaction to issuance of pooled income fund participations ("PIFs"), gift annuity contracts ("CGAs") and certain collectively invested trusts ("Certain Trusts") but does not exempt the issuer/trustee from the securities anti-fraud provisions of federal law. The states of Connecticut, Tennessee, Nebraska, Florida, Mississippi, Arkansas, Vermont, and Virginia have laws that meet the "opt out" requirements. Accordingly, state securities laws need to be addressed if a charitable organization is issuing CGAs, PIFs, or Certain Trusts to donors who are residents of these states. While not a treatise on all of the gifts in all of these states, the following are examples of possible solutions:

Connecticut: An exempt transaction is available for CGAs pursuant to other portions of the Blue Sky laws. No-Action letters should be pursued for PIFs and Certain Trusts. In the alternative, legislation could be pursued. Vermont: The Department of Banking, Insurance , Securities, and Health Care Administration ("BISHCA") regulates securities and insurance. CGAs are not regulated under the Securities Division but rather as part of its Insurance Division. The NAIC Model Exemptive Act will be introduced in the Vermont Legislature at the beginning of the 2001 legislative session. BISHCA has granted No-Action letters for PIFs. No-Action letters should also be obtained for Certain Trusts.

Tennessee: The Department of Commerce and Insurance regulates both securities and insurance. The Department regulates gift annuities under it's insurance section, in accordance with the new Tennessee law requiring permits for charitable gift annuities. No-Action letters should be sought for PIFs and Certain Trusts. Alternatively, marketing materials and simple offering circulars can be filed to register these gifts.

Florida: The Florida Department of Banking and Finance has granted opinion letters to charities recognizing purported exemptions for CGAs. Exemptions are purportedly available for CGA programs that comply with the insurance statutes of the state, according to Florida Department of Banking and Finance staff. However, the purported exemption does not extend to PIFs or Certain Trusts. Legislative action is needed to allow issuance of PIFs and Certain Trusts without onerous broker/dealer registration

and securities registration and to assure exemptions for CGAs. Current laws provide for civil and criminal penalties for failure to comply with the multiple registration requirements when issuing PIFs, Certain Trusts, and non-insurance complying CGAs.

Mississippi: No-Action letters should be sought for CGAs, PIFs, and Certain Trusts. Nebraska: Significant legislative history transcripts and Attorney General opinions make it clear that Nebraska regulates CGAs, PIFs, and Certain Trusts under securities laws. Until legislative action is taken to correct this, charitable organizations should seek to qualify as an "Issuer-Dealer" - a simpler form of examination for gift officers soliciting these gifts and charities that employee gift officers. Issuer-Dealer status is available to charities with offices in Nebraska.

Virginia: An Exemptive Order from the Securities Division of the State Corporation Commission is required in order to lawfully issue PIFs, CGAs, and Certain Trusts. The Division has routinely granted the Exemptive Orders to charitable organizations. Each charitable organization must have its own Exemptive Order.

Arkansas: No-Action letters should be sought for CGAs that already comply with the state's insurance laws, PIFs, and Certain Trusts. In the alternative, legislation could be pursued.

(A more complete description of the Florida Regulatory scheme in this area is attached as an Addendum to this paper.)

ADDENDUM

Thompson & Knight

A Professional Corporation

MEMORANDUM

TO:

FROM: Thompson & Knight

SUBJECT: Florida Blue Sky law "charitable issuer" exemption

DATE: _________________

The Philanthropy Protection Act of 1995

The Philanthropy Protection Act of 1995 (Pub. L. 104-62, the "PPA") was enacted at the federal level to provide specific exemptions from federal securities laws for certain collective funds maintained by qualified non-profit organizations. The PPA codified the established position of the Securities and Exchange Commission generally exempting securities issued by collective funds maintained by qualified non-profit organizations if such funds included only certain specified categories of assets, such as general endowments, charitable gift annuities and charitable remainder trusts, from the registration and reporting requirements under federal securities laws. In addition, Sections 6(a) and 6(b) of the PPA provided that the federal exemptions under the PPA would preempt similar state Blue Sky Law requirements for securities registration and reporting and broker-dealer and

investment adviser registration. However, under Section 6(c) of the PPA, states had the right to individually opt out of the Section 6(a) and (b) preemption provisions by enacting a statute to that effect within three years of the enactment of the PPA (ending December 8, 1998). Arkansas, Connecticut, Florida, Maryland, Mississippi, Nebraska, Tennessee, Vermont and Virginia elected to opt out of the PPA. However, by subsequent amendment to the Maryland Securities Act, Maryland effectively reversed its previous opt-out from the PPA, and only eight opt-out states pose Blue Sky concerns in connection with issuances of securities by charitable collective investment funds. Of these few states that opted out of federal preemption by the PPA, it appears that only Florida law is likely to impose any significant restrictions or costly compliance requirements on the fund raising efforts of charities that comply with the federal requirements of the PPA.

The Charitable Securities "Exemption" Under Florida Law

Florida opted out of federal preemption under the PPA under Section 517.051 of the Florida Securities and Investor Protection Act (the "Florida Act"). Florida's securities laws are administered by the Florida Department of Banking and Finance (the "Florida Department").

Section 515.07 of the Florida Act generally provides that it is illegal to offer or sell a security in Florida unless (i) the security is registered pursuant to the provisions of the Florida Act, (ii) the security is exempt under section 517.051 of the Florida Act, (iii) the security is sold in a transaction exempt under section 515.051 of the act, or (iv) the security is a federal "covered security" (as defined under the Section 18 of the Securities Act, which does not include securities offered in reliance on the Section 3(a)(4) of the Securities Act federal charitable offering exemption). Consequently, securities offered by a charity or a fund maintained by a charity relying upon the Section 3(a)(4) exemption from federal law, must either be registered in Florida or subject to an applicable state exemption from registration.

Section 517.051 of the Florida Act provides certain securities are exempt from the Section 517.07 registration requirements of the Florida Act. That section reads in relevant part as follows:

> Exempt Securities. . . . The registration provisions of s. 517.07 do not apply to any of the following: . . .
>
> (9) A security issued by a corporation organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, no part of the ne earnings of which corporation inures to the benefit of any private stockholder or individual, *or any*

> *security of a fund that is excluded from the definition of an investment company under s. 3(c)(10)(B) of the Investment Company Act of 1940*; . . .

(emphasis added)

The above italicized text establishes generally the same standard for exemption from Florida securities registration requirements as exists with respect to federal registration requirements following enactment of the PPA. The referenced Section 3(c)(10)(B) of the Investment Company Act was added to the Investment Company Act as one of the federal statutory amendments included in the PPA. This amendment to the Investment Company Act established the criteria upon which the PPA exemptions under the Securities Act of 1933 and the Securities Exchange Act of 1934 are also based. Consequently, although Florida opted out of the PPA, it has nonetheless generally exempted from registration the same securities issued by charitable collective funds as are exempted under the PPA. However, Section 517.051 continues:

> provided that no person shall directly or indirectly offer or sell securities under this subsection except by an offering circular containing full and fair disclosure, as prescribed by the rules of the department, of all material information, including but not limited to . . . [general types of information to be included, as described in detail under the Blue Sky Regulations described below]

Section 517.051 concludes with the PPA opt out provision:

> Section 6(c) of the Philanthropy Protection Act of 1995, P.L. 104-62, shall not preempt any provision of this chapter.

Given Florida's exemption from securities registration for securities issued by certain collective funds based upon Section 3(c)(10) of the Investment Company Act, the main substantive effect of Florida's opt out of the PPA is the requirement that securities exempt under 517.051(9) may nonetheless only be offered or sold by an offering circular containing certain prescribed information. Although an exemption from federal securities laws (and the preempted Blue Sky Laws of the non-opt out states) under the PPA requires certain basic disclosure, the disclosure requirements for the offering circular required for an exemption under Florida Blue Sky Law are substantially more demanding. *The registration exemption is only available for offerings or sales made pursuant to a satisfactory offering circular.* The specific informational requirements for such an offering circular are set forth in Rule 3E-400.001 of Florida's Blue

Sky Regulations.

The state has established different disclosure requirements for securities offerings of not more than $250,000 and for offerings in excess of $250,000. The more cumbersome requirements for offerings in excess of $250,000 are nearly as demanding as the disclosures required for a registration statement and include requirements for disclosure of information on the business and capitalization of the issuer, the use of proceeds from the issuance, executive compensation and inclusion of GAAP financial statements for the issuer. The Florida Department has interpreted Rule 3E-400.001 to apply without exception to all offerings claiming exemption under Section 517.051(9) (the charitable offerings exemption), and has held that the offering circular must disclose without exception all information delineated in the rule.

In addition to the requirement that "exempt offerings and sales" be made pursuant to an offering circular, the Florida Act's dealer registration requirements also apply. Rule 3E-400.002 of Florida's Blue Sky Regulations provides that an issuer of securities (such as a charity maintaining a collective investment fund) who elects to offer or sell its own securities pursuant to Section 517.051(9) is nonetheless required to be registered as a dealer pursuant to Section 517.12(2).

Liability Under Florida Law

Failure to provide each offeree a copy of the offering circular, as described above, will result in the loss of exempt status. Section 517.111(b) and (j) of the Florida Act provides that any application to register securities may be denied or revoked if the issuer fails to comply with any provision of Florida's securities laws or regulations or fails to timely complete an application for registration. Moreover, the Act's anti-fraud provisions explicitly include securities and transactions exempt from the registration requirements. Specifically, Section 517.301 prohibits fraudulent schemes and devices, including obtaining money or property by means of any untrue statement or omission of a material fact in connection with the rendering of any investment advice or in any connection with the offer or sale of any security. Under Section 517.302, a violation of any provision of the Florida Act is a third-degree felony, and a violation of Section 517.301 or Section 517.311 (which generally prohibits sales of securities made upon certain types of false representations such as the recommendation or approval of the securities by a governmental authority, etc.) that involves a sale aggregating in excess of $50,000 to five or more persons is a first-degree felony. Furthermore, the state is empowered to investigate and enjoin any violation or suspected violation of the Florida Act or regulations thereunder.

Section 517.211 grants the purchaser a right of rescission for any

failure to properly register securities under Section 517.07 or for any sale made by a person not registered if required to do so under Section 517.12, or for any violation of Section 517.301 (the anti-fraud provision). Section 517.211 also prescribes a remedy for recovery of a purchaser's actual damages. In addition, Section 517.241(2) grants generally a private right of action under any common law or statutory right to remedy any conduct involved in the sale of the securities or investments. Section 517.241(3) gives a litigant the same civil remedies as provided under federal law.

Regarding broker-dealer liability specifically, the anti-fraud provisions apply to any person involved in the transaction. Under Section 527.211, not only the person making the sale but "every director, officer, partner, or agent of or for the seller" if such person "has personally participated in or aided in making the sale," is jointly and severally liable for rescissionary damages for a sale made in violation of Section 517.07 (registration requirements) or Section 517.12 (dealer, investment advisor and agent registration requirements) or Section 517.301 (fraudulent transactions or misleading omissions or misstatements of material facts). Moreover, one Florida court has interpreted the term "agent" under Section 527.211 to include a public accounting firm that performed an audit of the seller in a leveraged buy-out. *Arthur Young & Co. v. Mariner Corp.*, 637 So. 2d. 1199, 1203 (Fla. Ct. App. 1994). Although *Mariner* did not involve a non-profit corporation, the court construed the definition of "agent" broadly in light of the legislative purpose of protecting the public against fraudulent and deceptive practices. *Id.* at 1204.

Conclusion

Florida is unique among all states in the level of burden, expense and legal risk imposed by its Blue Sky laws upon non-profit organizations and their employees and related funds in connection with the solicitation and "sale" of planned gifts that may be argued to constitute "securities". As a result of the enactment of the PPA, securities regulation and liability concerns with respect to planned gifts at the federal level and in the non PPA opt-out states have been substantially alleviated and research on the opt-out states other than Florida indicates that regulatory compliance and expense in those states should be manageable. Florida's "charitable exemption" regulatory framework however, which applies to any offer or sale of a "security" within the state (regardless of the existence or absence of any other contacts between the charity and the state), is nearly as burdensome as actual registration and may as a practical matter provide no "exemption" at all for many non-profit organizations that lack sophistication in securities laws or cannot afford the expense of engaging professionals to assist in preparation of the required offering circular. Under the existing Florida scheme, particularly given the potential for criminal liability based upon errors or omissions in the offering circular, it is unlikely that any but the largest of charitable organizations (or least knowledgeable) could justify or would be inclined to actively solicit planned charitable gifts within the state.

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