**Common Mistakes in Charitable Planning**

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# **Working with our Clients**

## Our clients make gifts in a number of ways, for example:

### through their estate plans (wills and trusts);

### by beneficiary designation on life insurance and retirement plans;

### gifts during their lifetime:

#### simple direct gift, or

#### subject to a gift agreement;

### more sophisticated planning vehicles:

#### charitable lead or remainder trusts,

#### donor Advised Funds, and

#### private Foundations.

## We often work with our partners in helping clients structure and then execute and satisfy the gifts.

## Some rules of the road to be mindful of as you plan and assist clients.

# **Satisfaction of a Personal Pledge of a Disqualified Person by the Private Foundation**

## Impact: A grant by a private foundation in satisfaction of a personal pledge of a disqualified person is an act of self‑dealing. Care should be taken when entering into pledge agreements when a client makes individual contributions and when he makes contributions through his donor advised fund or private foundation.

## Summary:

### Internal Revenue Code Section 4941 (“Code Section”) imposes a penalty tax on certain transactions between a private foundation and any disqualified person.

### A disqualified person is any substantial contributor to the foundation, any director of the foundation, any owner of more than 20% of any substantial contributor (a "20% owner"); any family member of a substantial contributor, a foundation manager, or a 20% owner (a "family member"); any corporation in which more than 35% of its voting power is owned by a substantial contributor, a foundation manager, a 20% owner or a family member; any partnership in which more than 35% of the profits interest is owned by a substantial contributor, a foundation manager, a 20% owner or a family member; or any trust or estate in which more than 35% of the beneficial interest is owned by a substantial contributor, a foundation manager, a 20% owner, or a family member.

### Self-dealing includes any direct or indirect: (i) sale or exchange or leasing of property between a private foundation and a disqualified person, (ii) lending of money or other extension of credit between a private foundation and a disqualified person, (iii) furnishing of goods, services or facilities between a private foundation and a disqualified person, (iv) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person, or (v) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation (each an "Act of Self-Dealing").

# **Can Disqualified Persons Attend Charitable Dinners and Golf Outings?**

## Impact: It is best for private foundations to have policies in place that prohibit sponsorship payments where a benefit will be received by the foundation. If a private foundation decides to make these types of grants, it could donate the tickets (or other event benefits) to a charitable cause. The best option, however, is for the disqualified person to make the sponsorship payment from his or her own funds if he or she wishes to have family members attend these events.

## Summary:

### Many organizations raise money by hosting charitable dinners, dances, golf outings or similar events. For individual donors, the cost of the event reduces the amount of the donor’s charitable contribution. What happens when a private foundation sponsors one of these events and receives benefits in return?

### As discussed above, Code Section 4941 prohibits most transactions between a private foundation and a disqualified person. Specifically prohibited is the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

### Thus, a private foundation’s officers, directors and employees may attend the event hosted by the charity if they are attending the event in their official capacity as representatives of the foundation. However, other disqualified persons, such as family members who are not officers, directors, or employees of the foundation, would not fit within the foregoing exception because they would presumably not be acting in an official capacity as foundation representatives.

### Would the answer be different if the sponsorship payment was bifurcated so that the private foundation paid the charitable component and the disqualified person paid the “return benefit” portion?

### A private foundation and related for-profit organization proposed to share the cost of sponsoring charitable fundraising events, with the private foundation paying the portion allocable to the charitable contribution and the for-profit paying the portion allocable to the fair market value of meals, entertainment, and other benefits. Presumably, the intent of this arrangement was to avoid the provision of benefits by the private foundation to disqualified persons. However, under the proposed arrangement, the for-profit would directly benefit from the contribution of the private foundation by receiving meals and entertainment associated with the full cost of a sponsorship while paying only a fraction of the cost. The IRS ruled that such an arrangement would constitute an impermissible act of self-dealing. Furthermore, the IRS stated that the result would be the same under any funding arrangement pursuant to which the private foundation's funds enabled the for-profit's executives to attend fundraising events.

# **What Rights May a Donor Retain and Not Affect the Charitable Contribution Deduction?**

## Impact: Any right retained by a donor must be carefully scrutinized to ensure that it will not be considered substantial enough to disqualify the donor from the charitable deduction.

## Summary:

### To qualify as a charitable contribution (and thus entitle a donor to a charitable deduction), a gift must be irrevocable and complete. In general, there can be "no strings attached" to the gift.

### A donor may retain insubstantial rights in a gift if those retained rights do not interfere with the charity's interest in the gift. For example, a donor's gift of land with the restriction that he retain the right to train his hunting dogs on the land was considered an insubstantial right and did not affect the donor's charitable deduction.

### The IRS has determined that the retention of certain display rights with respect to the contribution of artwork to a museum was not substantial enough to impact the charitable deduction.

### A donor can make non‑binding recommendations to the charity regarding the administration of the gift; however, to preserve the charitable deduction for the gift and the tax‑exempt status of the charity, some independence must exist between the charity and donor. Thus, the charity must have the ultimate control and power over the use of the gift.

### A charitable income tax deduction is not allowable if a transfer for charitable purposes is dependent on the performance of some act or the happening of a precedent event in order for the transfer to become effective unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. Similarly, if a transfer for charitable purposes may be defeated by the performance of some act or the happening of some event, no deduction is allowable unless the possibility that such act or event will occur is so remote as to be negligible.

### Generally, a donor may also restrict a contribution to a qualified charity for a particular purpose or use without jeopardizing the charitable deduction, provided that such restrictions do not prevent the charity from freely and effectively using the contributed property in furtherance of its exempt purposes.

### The IRS has ruled that a donor's retention of the right to manage the portfolio of publicly traded securities given to charity would not preclude the donor's income and gift tax charitable deductions. The donors gave cash and marketable securities to a college, subject to an agreement that the gifted assets be placed in a brokerage account in the name of the charity for its exclusive benefit, with management authority retained by the donors. The account could be invested only in U.S. equities, mutual funds and fixed‑income securities, offshore/onshore hedge funds, real estate investment trusts, and private placements and could not be invested in any company in which a donor held, directly or indirectly, more than five percent of the stock. The college could withdraw the assets from the accounts or terminate the management agreement at any time. If not earlier terminated, the management agreement would end in ten years.

# **Enforcing Donor Intent – Reservation of Right to Enforce the Contract**

## Impact: Gift agreements containing a reservation of rights to enforce the contract and/or rights of reverter (return to the donor or others), should be carefully drafted in order to avoid the loss of charitable deduction.

## Summary:

### If an interest in property passes to, or is vested in, charity on the date of the contribution, but the interest could be defeated by a subsequent act, an income tax deduction will be disallowed, unless the occurrence of such act is “negligible.”

### For example, if a donor transferred land to a city government for so long as the land is used as a public park, the donor would be entitled to charitable deduction so long as on the date of the gift, the city planned to use the gift as a park and the possibility that it will not use the land for a park is so remote as to be negligible.

### Additionally, if a taxpayer receives a charitable contribution deduction in the year of the contribution, and the charity is later required to repay the contribution, the taxpayer would be required to include the amount of the previous deduction in his or her gross income in the year that the charity repays the contribution. *See* IRS Information Request by Rep. Kay Granger (R-Texas).

# **Selection Clauses**

## Impact: If a charitable deduction is intended, care should be taken in drafting clauses that allow for selection of beneficiaries or property.

## Summary:

### If, at the date of the decedent's death, a charitable transfer depends upon the performance of some act or happening of some event before becoming effective, no deduction is allowed unless the possibility that the charitable transfer will fail is so remote as to be negligible.

### For example, a doctor left his residuary estate to two universities, but empowered his personal representative to make distributions to individuals who helped the doctor in his final illness, at the personal representative's discretion. The testator placed no limit on the number of persons who could receive distributions, but did place a limit on the amount of distribution to each individual. Because the amount passing to charity was at the discretion of the personal representative, the Court held that the charitable bequest was not deductible.

### Similarly, no charitable deduction would be allowed in circumstances where a charity is named as the default beneficiary for items of property that are not selected by the named individual beneficiary.

### Proper drafting to provide for a disclaimer to charity would result in a charitable deduction.

# **International Grant making by an Individual**

## Impact: Because contributions by an individual to foreign organizations are not deductible, advisors should consider alternate ways to support charities abroad.

## Summary:

### The Code provides a deduction from federal income tax for any charitable contribution paid during a taxable year.

### A "charitable contribution" is defined under the Code as a contribution to a corporation created or organized ***in the United States*** that is organized and operated exclusively for a charitable purpose.

### The Service has ruled that if a grantee organization was not created or organized in the United States, a contribution by an individual to such an organization is not deductible.

# **International Grant making by a Private Foundation**

## Impact: While grants may be made to a foreign grantee, it is important to develop policies and procedures so as to avoid excise taxes on such grants. Further, it is important to remember that grants to foreign grantees generally will not qualify as a qualifying distribution.

## Summary:

### Private foundations can make grants to a foreign organization. However, private foundations must satisfy certain requirements to avoid being taxed on those distributions to foreign grantees.

### A private foundation generally must distribute a certain minimum amount of its property as a "qualifying distribution" in furtherance of its charitable purposes. Otherwise, the foundation will be taxed on the amount of undistributed income. A distribution to a foreign organization generally will not be considered a "qualifying distribution" unless the private foundation makes a "good faith determination" that the foreign organization is equivalent to a domestic public charity. This rule does not apply if the foreign organization has obtained a ruling from the Service classifying it as the foreign equivalent of a public charity.

### A private foundation generally is considered to have made a good faith determination when it receives an affidavit from the foreign grantee or an opinion of legal counsel that the foreign grantee is equivalent to a domestic public charity.

### Additionally, any grants that a private foundation makes to a foreign organization generally will be treated as a taxable expenditure unless the foundation either determines that the foreign organization is equivalent to a domestic public charity (by making a "good faith determination," as explained above) or exercises expenditure responsibility with respect to the grant.

### In order to exercise expenditure responsibility, the foundation generally must establish procedures to monitor the use of funds by each foreign grantee, conduct a pre‑grant inquiry of each foreign grantee, enter into a grant agreement with each foreign grantee that contains specific terms regarding use of the grant, and report specific information about each foreign grant on its Form 990-PF.

# **Substantiation Letters**

## When do they need to be issued?

### Impact: The substantiation requirements vary depending upon the type and value of the property contributed. Ultimately, the taxpayer bears the burden of establishing that the substantiation requirements have been met.

### Summary:

#### A charitable contribution is deductible only if the contribution is verified under the requirements of Code Section 170. The substantiation requirements vary widely depending on the type and value of the property contributed.

#### With respect to cash, contributions over $250 must be acknowledged by the donee organization with a "contemporaneous written acknowledgment." Cash contributions less than $250 require bank record or written communication from the donee.

#### With respect to property, contributions over $250 but under $500 must be acknowledged by the donee organization with a "contemporaneous written acknowledgment." In addition, with respect to contributions over $500 but under $5,000, the records must also contain the date and manner the property was acquired or created as well as the adjusted basis for property other than publicly‑traded securities. In addition to the foregoing requirements, for contributions over $5,000, the taxpayer must obtain a qualified appraisal, conforming to the requirements under Treasury Reg. 1.170A‑13. The donee organization is not required to place a value on an in-kind contribution in the substantiation letter.

## Quid pro quo contributions

### Impact: Any quid‑pro quo contributions over $75 must be acknowledged in writing and contain statements regarding the value of goods and services received and limitation of the deduction.

### Summary:

#### A quid pro quo contribution is a payment to a charity that is made partly as a contribution and partly for goods and services.

#### Any organization that receives a quid pro quo contribution in excess of $75 must provide the donor with a written statement acknowledging that the amount that is deductible is limited to the difference between the contribution less the value of the goods or services provided. The statement must also provide a good‑faith estimate of the value of the goods and services provided by the organization.

## Recent Cases where No Substantiation lead to No Deduction

### Taxpayer claimed $4,143 in charitable contribution deductions. He kept no records regarding the claimed contributions. Taxpayer testified in vague terms about having made gifts of clothing and cash to the Salvation Army. The Court determined that he was not entitled to any deduction for these contributions.

### The taxpayer in this case originally did not itemize her deductions. However, during the proceedings she asserted her right to itemize her deductions and claimed a number of charitable contribution deductions. The court allowed a number of charitable deductions. However, the Court denied deductions of $2,400 and $7,500 because the taxpayer did not receive a contemporaneous written acknowledgment from the donee organization.

# **Assignment of Income Doctrine – When Is It Too Late to Make the Charitable Gift and Avoid Capital Gain?**

## Impact: If avoidance of capital gain on the sale of appreciated securities is the goal, it is important to make sure that the right to income has not "ripened" at the time of transfer. Otherwise, the gain on the sale may be taxed to the donor, despite the transfer to charity.

## Summary:

### The assignment of income doctrine provides that income is taxed to the person who earns the income or otherwise creates the right to receive income. The mere anticipation or expectation of income at the time of a transfer, however, is insufficient to create a fixed right to earned income.

### Court decisions and IRS pronouncements:

#### Taxpayers transferred shares to a private foundation. The taxpayers controlled the corporation and the foundation to which the shares were transferred. A day after the shares were transferred, the corporation redeemed the shares. The corporation deducted the value of the shares contributed to the foundation and the IRS challenged this deduction arguing that there was an anticipatory assignment of the proceeds of the redemption. The Court rejected the application of the assignment of income doctrine, and the IRS acquiesced to the decision and adopted a bright‑line test that provides that the assignment of income doctrine will apply only if the donee is legally bound or can be compelled to surrender or redeem the shares.

#### Despite the IRS's position, Courts have not applied the bright line test, as adopted by the IRS, as the sole test for resolving anticipatory assignment of income issues. The donee's control is merely a factor, albeit an important one.

#### Despite the failure to adopt the bright line test across the board, Courts in applying other reasoning to resolve assignment of income issues have relied on similar tenants that embrace the theory behind the bright line rule. The Tax Court stated that the "ultimate question is whether the transferor, considering the reality and substance of the circumstances, had a fixed right to income in the property at the time of transfer." And, once the right to receive income has "ripened" for tax purposes, the taxpayer who earned or created the right will be taxed on the gain realized from it, despite the fact the right to receive income was transferred by the taxpayer.

#### To determine whether a right has "ripened" the court must "consider the realities and substances of the events to determine whether the receipt of income was practically certain to occur."

#### Courts have also rejected taxpayers’ attempts to "impose formalistic obstacles" to the application of the anticipatory assignment of income doctrine.

# **Gifts of S Corporation Shares**

## Limitation on Charitable Deduction

### Impact: Many times closely-held S corporation shares have low basis, so a private foundation may not be the optimal grantee organization.

### Summary:

#### For contribution of S corporation shares to a private foundation, the deduction would be limited to the donor's *cost basis* in the shares.

#### If the contribution is to a public charity, the donor's charitable contribution would be equal to the fair market value of the shares; however, the deductibility of the contribution would be limited to 30% of AGI (instead of the normal 50% for contributions to public charities).

## Unrelated business income tax consequences to charity

### Impact: Transfer of S corporation shares to charity does not increase the net amount passing to the charity, because the charity will still be required to pay the tax on the gain at the highest corporate rate.

### Summary:

#### If an exempt organization regularly carries on a trade or business not substantially related to its exempt purpose, the organization is subject to tax on its income from such unrelated trade or business. This tax is known as the "Unrelated Business Income Tax" or "UBIT."

#### Ownership of S corporation shares is treated as ownership of an interest in an unrelated trade or business. Thus, any charitable organization that holds such shares will be subject to UBIT on the income of such shares. Additionally, all gain or loss on the sale of the shares by a charitable organization will also be subject to UBIT.

## Excess business holdings to private foundation

### Impact: It is important to plan for the eventual sale of S corporation shares gifted to a private foundation or donor advised fund.

### Summary:

#### A 10% penalty tax is imposed on the amount of a private foundation's ownership of more than a 20% interest in a trade or business. When determining whether a private foundation owns more than 20% in a trade or business, the foundation's holdings are aggregated with those of any disqualified person.

#### A disqualified person is any substantial contributor to the foundation, any director of the foundation, any owner of more than 20% of any substantial contributor (a "20% owner"); any family member of a substantial contributor, a foundation manager, or a 20% owner (a "family member"); any corporation in which more than 35% of its voting power is owned by a substantial contributor, a foundation manager, a 20% owner or a family member; any partnership in which more than 35% of the profits interest is owned by a substantial contributor, a foundation manager, a 20% owner or a family member; or any trust or estate in which more than 35% of the beneficial interest is owned by a substantial contributor, a foundation manager, a 20% owner, or a family member.

#### Additionally, if the foundation does not divest itself of such excess shares within a certain period of time, the foundation will incur a tax equal to 200% of the value of the excess shares.

#### If there is a change in the holdings in a business enterprise due to a gift or bequest, but not by purchase by the foundation or a disqualified person, which causes the foundation to have excess business holdings in the business enterprise, the amount of the increase in the beneficial interest of the foundation in such business enterprise immediately after such change (but not the beneficial interest held prior to such change) shall be treated as held by disqualified persons only, rather than by the foundation (thereby alleviating it of the liability for taxes on the amount of the increase), during the 5-year period beginning on the date of such change in holdings.

## Ownership by Charitable Remainder Trust

### Impact: An S Corporation will lose its S Corporation tax status on the day that a charitable remainder trust becomes a shareholder, and will thereafter be taxed as a C Corporation. However, the corporation may be eligible for relief from the termination of its S Corporation status under Code Section 1362(f).

### Summary:

#### A charitable remainder trust is a trust in which a certain amount, either an annuity or unitrust, is payable to an individual or individuals either for their lives or a term of years. Any amount in excess of what is distributed to the individual beneficiaries is accumulated for the charitable remainder beneficiaries.

#### Under Code Section 1361, only individuals, estates, and certain trusts described in Section 1361(c)(2)(A) can own shares of an S Corporation. A charitable remainder trust, as defined in Section 664 does not qualify as a "subchapter S trust" under Section 1361. Thus, a charitable remainder trust is not a permissible shareholder of S Corporation shares.

## Ownership by Charitable Lead Trust

### Impact: A charitable lead trust is a permissible owner of S corporation shares. However, if the charitable lead trust is not a grantor trust, there may be significant tax consequences that would cause the charitable lead trust to fail (i.e., not have funds available for distribution at the end of the charitable term).

### Summary:

#### Charitable lead trusts (both grantor and non-grantor) are permissible shareholders of S corporation stock. Grantor charitable lead trusts are permissible shareholders because of their “grantor trust” status. Non-grantor charitable lead trusts can elect to be an Electing Small Business Trust (ESBT), which would qualify the non-grantor charitable lead trust as a permissible shareholder.

#### A ESBT is treated as two trusts: the “S portion” (taxable income to S Corporation stock) and “non-S portion” (income generated by other investments). An EBST is subject to tax at the highest income tax rate on the entire S portion of the trust, and charitable contribution deductions are generally not allowed for distributions from the S portion.

#### Additionally, a non-grantor charitable lead trust is subject to the excess business holdings rule under Code Section 4943. Code Section 4943 imposes a 10% penalty tax on the amount of a private foundation’s ownership of more than a 20% interest in a trade or business.

# **Designation of a Private Foundation as the Beneficiary of a CLT**

## Impact: When naming a private foundation as beneficiary of a CLT, it is important to understand the applicability of the expenditure responsibility rules. Further, changes to the private foundation’s governance documents will be necessary to avoid estate tax inclusion issues.

## Summary:

### All qualified CLTs are subject to the private foundation excise taxes for making jeopardy investments, retaining excess business holdings, engaging in acts of self‑dealing, and making taxable expenditures. When making charitable distributions to a private foundation, a taxable expenditure may occur if the CLT fails to exercise expenditure responsibility.

### Code Section 4945 prohibits a private foundation from making taxable expenditures. A taxable expenditure includes, in part, any amount paid or incurred by the foundation as a grant to an organization, unless such organization is an organization exempt from federal income tax under Code Section 501(c)(3) and is not a private foundation under Code Section 509.

### Does a CLT need to exercise expenditure responsibility? IRS rulings provide guidance on this question. If the private foundation is identified in the trust by name, there is no need to exercise expenditure responsibility. If, however, the trustee is given discretion to make grants to a private foundation and it does, then expenditure responsibility is required.

### Code Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (i) the possession or enjoyment of, or the right to the income from, the property, or (ii) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

### Thus, if the CLT will distribute funds to the donor’s private foundation, the donor should not be involved in making grant decisions regarding the funds received from the CLT. For example, the IRS ruled that the property in the CLT would not be includible in the settlor's gross estate, even though he was an officer of the private foundation that was the lead beneficiary, because the funds received by the foundation from the CLT had to be held in a segregated fund as to which the Settlor had no control.

# **Disclaimer into a Donor Advised Fund or Private Foundation**

## Impact: It is important to remember that the disclaimant must not possess the power to direct where the disclaimed interest passes, even if it is his or her capacity as one of several directors of a nonprofit corporation.

## Summary:

### A qualified disclaimer under Code Section 2518 causes the disclaimed interest in a gift to be treated as if it had never been transferred to the person making the qualified disclaimer for federal gift tax purposes, and instead is treated as passing to the person entitled to receive the property under the terms of the instrument or state law.

### One of the requirements for a qualified disclaimer is thatthe interest passes, without any direction on the part of the person making the disclaimer, to the decedent's spouse or to a person other than the person making the disclaimer.

### When disclaiming to a donor advised fund or private foundation, special issues arise related to whether the disclaimer meets the requirement that the disclaimed property passes without any direction on the part of the person making the disclaimer.

### Example: a decedent left property to her grandchildren in trust. The trust provided that if a grandchild disclaimed all or a portion of his or her inheritance that the disclaimed portion would pass to a donor advised fund that would include the grandchild's name in the title and authorize the grandchild to serve as an advisor to the fund. The IRS found that the disclaimed property would pass without direction from the grandchild, and therefore held that the disclaimers were qualified.

### Example: Similar facts as above, but the final contingent beneficiary was a private foundation of which the son was the president and a director. The IRS found that a disclaimer by the son would only be qualified if the bylaws of the private foundation were amended to provide for a segregated fund for the disclaimed property. That separate fund would be managed by three special directors who were not appointed by the son. The son could not serve as a special director and the property in the segregated fund could not be co‑mingled with the other foundation assets until the death of the son. With these qualifications, there would be a qualified disclaimer.

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