Steve Leimberg's Charitable Planning Email Newsletter - Archive Message #183
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From: Steve Leimberg's Charitable Planning Newsletter

Subject: Jeff Baskies' Top 10 List of Philanthropic Topics Addressed at the 2012 Heckerling Institute

Charitable planning is not often foremost at the annual **Heckerling Institute**. Perhaps due in part to the relative stability in the laws governing most philanthropic issues, the subject tends to be less in the spotlight. However, as usual, there were charitable tidbits presented, and there were a number of developments significant enough to warrant review. In fact, looking back, charitable planning played a substantial role in this year's institute: (a) it was touted as perhaps the most viable option for certain IRA planning, (b) it was the panacea for gift tax valuation disputes via defined value formulas (ala Petter and Hendrix), and (c) it was presented as the most viable option for clients with valuable collectible art.

Given the prominence of charitable planning in this year's institute, Jeff Baskies has picked out 10 of the most interesting and important presentations on philanthropic topics delivered at the institute, at least they were to him.

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Here is his commentary:

EXECUTIVE SUMMARY:

Charitable Planning plays an important role for advisors working with families of all levels of wealth. We should not assume these topics are only relevant to the richest of our clients, as many charitable donors have extremely modest estates, while some

clients of extreme wealth provide little to charity. While many other tax planning opportunities have changed over time, one opportunity that has remained stable is the gift and estate tax charitable deduction. It is vital to our roles as advisors that we are comfortable helping our clients make meaningful philanthropic gifts and integrating charitable planning into their estate planning.

With that in mind, while attending the University of Miami Heckerling Institute in January and reviewing the materials for a presentation, I realized there were many worthy charitable-oriented discussions in the materials. To ease parsing the philanthropic topics from the rest of the subjects, I created this top 10 list to help those who wish to review the materials.

COMMENT:

So here are the Top 10 Philanthropic Topics addressed in a sort of chronological order:

1. 1/9 – **Dennis I. Belcher, Carol A. Harrington** and **Jeffrey N. Pennell** – Recent Developments - 2011

Using materials produced from a variety of sources and edited by **Ron Aucutt**, the Recent Developments panel offered insights to many cases, rulings and other current topics and trends in 2011. One such topic was the growing trend of defined value formula clauses defeating IRS challenges, particularly where charities are involved.

In 2011, the Ninth Circuit affirmed a 2009 Tax Court approval of the use of a defined value formula clause in Petter v. Commissioner, 653 F.3d 1012 (9th cir 2011). The Petter case involved a large gift and sale of UPS stock via a FLP and a pair of grantor trusts to which Anne Petter made gifts and sales. The gifts were based on defined formulae referring to the dollar amount that can pass free of federal gift tax. The sales provided for assignments of FLP interests defined as "the number of units that equal in value $4,085,190 as finally determined for federal gift tax purposes – which apparently equaled 9 times her remaining gift tax exclusion, thus making the gift 10% and the sale 90%. Naturally, she took back interest-bearing notes on the sale. Each gift was defined thus by formula and a number of units was assigned. The trusts provided that any excess over the formula amounts would pass to two community foundations.

Citing to Christiansen and McCord before, Judge Holmes in the Tax Court

distinguished this type of defined value formula from the one in the Procter case. The big difference, the opinion cited was one where a person "gives away a fixed set of rights with uncertain values … and one who tries to take property back." The first scenario in shorthand was the Christiansen/Petter case which by formula impacted the allocation but did not allow for the donor to get the property back (as in Procter).

Subsequently, the Tax Court again sustained the validity of the defined value formula technique in Hendrix v. Commissioner, T.C. Memo 2011-133. In that case, the taxpayers gifted to trusts for their children nonvoting shares in a closely held company. Simultaneously the taxpayers made gifts to a donor advised fund they established at the Greater Houston Community Foundation. In Hendrix, the taxpayers negotiated for several months with the foundation to determine the precise terms of the gift to the fund. The gift to the trust was thus defined as a portion of the stock determined by a defined value formula with any excess going to the foundation.

Again citing to McCord, the Tax Court upheld the validity of the defined value formula in Hendrix. Based on the case's unique facts, the court found that the transactions were at arm's length and the foundation was independently represented and participated in the structure of the transaction and the split of the shares.

In the materials, **Steve Akers** contributed a summary that noted we now have 4 cases recognizing such defined value clauses in gift tax planning. They are McCord, Christiansen, Petter and Hendrix. From them, two different approaches have emerged. The first approach in McCord and Hendrix allocated the transferred shares based on a "confirmation agreement" among the recipients. The second approach in Christiansen and Petter allocated the transferred shares based on values as finally determined for estate or gift tax purposes.

The panel discussed these cases in depth. In his review of this subject, Prof. Pennell highlighted the important role of the community foundations (the charities in these cases) in strengthening the taxpayers' positions. Prof. Pennell also stressed (and noted the same in the materials) that the facts in Petter not only involved a charity as "spill over" beneficiary (not a spouse, or a GRAT as pour-over beneficiary), but the charity was involved in arm's-length negotiations, had its own counsel and won changes in the transfer documents designed to protect their interests. Plus, in both cases, at least something was paid to the charity immediately – although Prof. Pennell insightfully questioned just what was "substantial enough" to give one comfort. Thus, he pointed to several elements which taken together increased the chances of

success: a present interest gift to the charities, the community foundations' active involvement in the transactions, active negotiations, independent counsel and the independence of the charities – the community foundations were not controlled by the donors or their families, like family foundations would be. Perhaps, given all of these elements, the court felt confident the transaction was entered into in good faith.

For those planners seeking to align their planning with Petter, Hendrix and the other cases, it may be wise to ensure there is some meaningful present interest gift for the charity and that they chose a community foundation that is willing to have representation and involvement in the planning.

2. 1/10 – **Prof. Chris Hoyt** presented "IRA distributions and Rollovers – Integrating Estate Planning and Income Tax Planning.

An extremely positive charitable planning discussion came in Prof. Hoyt's presentation. He posited a scenario where an IRA owner dies and a relatively old surviving spouse considers a roll-over. In such a case, he noted, the rules require exhaustion of the IRA within a relatively short time period. An alternative solution for older clients with older spouses, Prof. Hoyt presented, was the use of a Charitable Remainder Trust ("CRT"). When a CRT is the designated beneficiary of an IRA, you avoid one of the most significant adverse consequences of a roll-over, because the CRT can have a constant payout (e.g. 5% per year) rather than the escalating exhaustion payout rates required of a rolled-over IRA. In addition, of course, the CRT may have successor beneficiaries (if they are old enough – generally at least in their 40s he suggested to ensure satisfaction of the 10% remainder test) so the children might continue the benefits of the annual payouts after the surviving spouse's death without worrying about the minimum distribution rules.

Prof. Hoyt noted how the use of an IRA to fund a Credit Shelter Trust ("CST") particularly a conduit trust might be very tax inefficient. When comparing a CST to a CRT for the first spouse to die's IRA, he argued for the CRT as the better and more flexible alternative, tax-wise.

Naturally, the CRT is also a viable option where the owner has no spouse and wishes to use it for her/his children. This can control the "burn rate" of the IRA post-death and also restrict just how much the children receive annually (avoiding beneficiaries possibly cashing out more quickly than the client wishes and/or the conduit trust rules).

Prof. Hoyt did note that portability makes the spousal roll-over a bit easier and more tolerable (if it is here to stay) than under the old rules (where sometimes IRAs were used to fund Credit Shelter Trusts). He said comparing funding a CST to a CRT often made the charitable plan far more attractive. The option of using the portability exemption along with a spousal roll-over may bridge that gap and practitioners perhaps now need to consider that more closely.

Also, in his Wednesday afternoon focus series program, Prof. Hoyt suggested clients consider a charitable bequest of a portion of their retirement accounts since charities pay no taxes. Similarly, he suggested clients should name charities as contingent beneficiaries in case the primary beneficiaries disclaim. If this planning might work for your clients, it seems like a fairly easy modification to add to beneficiary designations, and it may provide a powerful alternative to life-time withdrawals. One idea might be to designate a community foundation as the contingent beneficiary so a disclaiming primary beneficiary might avail herself of a community foundation's donor-advised fund to provide input as to the charitable distributions of the IRA funds post-disclaiming. It was asserted that such "control" should not render a disclaimer invalid since a donor advisor of a donor advised fund can only make recommendations. That conclusion appears logical, but of course advisors should consider this issue themselves.

Finally, on a personal note, I want to thank Prof. Hoyt for being gracious and funny even at a cocktail party at the Breakers Resort.

3. 1/10 – **Joshua S. Rubenstein** - Pressing The "Do Over" Button: Strategies for Modifying Wills and Trusts After Formation

Josh Rubenstein mentioned that trust reformations are statutorily allowed in some cases, including charitable split interest trusts, which can be modified if the trust would otherwise be disqualified from a charitable deduction.

He also addressed the issue of litigation settlements involving charitable deductions. If a will contest, for example, is settled and money passes to a charity, then in order to qualify that charitable gift for a federal estate tax charitable deduction, Josh said the charitable component must be allowable under state law (assuming the settlement is court approved, that should be easy), must pass from the decedent (as opposed to coming from a beneficiary), must be paid from an interest that is included in the gross estate (seems obvious, I guess, but perhaps some have tried to claim deductions for

assets not even in the decedent's gross estate), must pass to a charity that qualifies for a deduction under section 2055 and must be payable as part of a bona fide contest.

The discussion of settlements was quite interesting. Many probate administrators and litigators have seen will contests that could settle if some portion of the estate went to a charity and a deduction were available, but you can't simply agree to do so. There must be some bona fide dispute that is being settled and there must have been some right of the charity to receive the funds from the decedent. As much as litigants may want to, they can't simply re-write wills or re-write beneficiary designations and claim a charitable deduction.

4. 1/10 – **Ralph E. Lerner** – The Last Picture Show – What You Should Do With Your Art

What a wonderful presentation on philanthropy!! Ralph asked: What should you do with your art? And the number one answer to almost every question seemed to be: give it away to charity.

Ralph addressed giving collectibles such as art during life and at death. He focused on CRTs (inter vivos and testamentary), public charities, private foundations and other gift forms. He mentioned fractional interest gifts of art, sales with lease-backs and the many valuation issues attendant to all charitable gifts of art.

For a client making a lifetime gift, he said, the first issue a client needs to address is the status of the charity as either public or private. He stated that you only can deduct your costs for a contribution of art to a private charity, whereas you can deduct the fair market value for art donated to a public charity that satisfies the related use rule. Also, he said for some clients it could be an issue if the art is treated as capital gain property or ordinary income property (generally an issue for the creator of the work – the artist – or her family and for dealers), and such should also be considered prior to recommending a gift.

Next, Ralph suggested that as a result of the Pension Protection Act of 2006, a once popular technique of making partial interest gifts of art works is no longer viable or desirable. The IRS now essentially imposes time limits and valuation limits when partial interest gifts are made which makes the technique much less valuable to clients.

Another interesting twist on the fractional interest gifting was a discussion of the "fact" that there really is no market for fractional interests in art. There is no real

rental market either. This makes fractional interest gifts of art as well as sales or gifts with subsequent rental very tricky and difficult. In a leading case (Scull v. Commissioner), the IRS only conceded a 5% fractional interest discount for an estate's interest (65%) in an art collection. Apparently that case and other developments lead Mr. Lerner to conclude that fractional discounts in art transfers are not very appealing either.

In the end, whether suggesting outright inter vivos gifts, testamentary gifts, public charities or private operating foundations, it seemed the answer to most every question regarding "what should I do with my valuable art" was "give it to charity". The rules on how to make donations of art to charity may be tricky, and the valuations may be complex, but the advice to collectors seems uniform: give it away.

On a personal note based on the very limited sampling – i.e. my practice - I think Ralph's advice is right on point. It seems a fairly universal problem for clients and his suggested answer seems to fit many scenarios. For example, many clients who collected valuable art are faced with a tough choice of how to leave it. Often one child values it but the others do not. Nevertheless, seldom do any of the children value the art enough to be made responsible for the estate tax associated with inheriting it. Thus, gifts to public charities or private foundations for collectible art seem to create positive results for clients.

5. 1/11 – **Beth Shapiro Kaufman** – Gift Tax Audits: A Tale Of Two Initiatives

Beth reported that although the IRS had literally no activity for decades in the area of 501(c)(4) organizations (civic leagues and social welfare organizations), in May 2011, it opened audits of 5 taxpayers contributions to such. The IRS was apparently asserting a claim for gift tax on the transfers to the organizations, which are tax exempt to some extent (and thus loosely fit into our philanthropic topic subject matter update). While 501(c)(4) organizations are not specifically exempted from the gift tax, contributions to them had not been subject to gift tax arguments from the IRS for a very long time, apparently.

Beth reported that there was some grumbling in Washington about political motivations behind this initiative. Unlike 501(c)(3) organizations 501(c)(4)'s can lobby for legislation and participate in political campaigns and elections. Of course, contributions to such organizations are not deductible for income tax purposes, but many assumed contributions were not taxable gifts. Ultimately, on July 7, 2011, the deputy commissioner of the IRS announced that it would close all pending

examinations and would not expend resources on additional ones. Thus, while not purely philanthropic, it is interesting to note that the current situation for donations to such organizations may change rapidly and without notice.

6. 1/11 - **Alan F. Rothschild** and **Richard L. Fox** - Fundamentals Program #2 - What Every Estate Planner Needs to Know About Tax-Exempt Organizations and Charitable Gift Planning

There was an entire fundamentals program dedicated to reviewing how to advise clients on charitable gifts both during life and at death. Given the 800 pages of materials and over 3 hours of presentation, obviously the scope of the materials goes far beyond what can be covered in this summary.

One topic of obvious timely interest is the inter vivos charitable lead trust ("CLT"). Now is the time for CLTs. We have low interest rates (the lowest ever recorded), low value assets (declining real estate values may make for good opportunities) and a new $5 million gift exemption which makes a taxable remainder to a CLT more tolerable for clients. And I am fascinated by the discussion of "shark fin" CLATs (although not directly part of this presentation). It seems increasing payout CLTs offer terrific solutions to many client planning needs.

There was a discussion of private operating and non-operating foundations and comparison to community foundations and donor advised funds. Each form of giving has its pluses and minuses, including the amount of the donation, the need for family control (multi-generational), the impact of deduction limits, and more. These days many community foundations are offering relatively simple and inexpensive private foundation alternatives with nearly all the same bells and whistles clients want from their foundations (donor advised funds have flexible investments, the ability to name multi-generational donor advisor successors and such), so particularly for "smaller" gifts, this option should be explored.

Mr. Rothschild noted that donors wishing to restrict gifts to charity should be careful in drafting their agreements, as too many restrictions and the potential for the funds to revert might eliminate any charitable deduction. In the event a gift is highly conditional (e.g. to be used to build a building with my name on it by January 1, 2013), one way to preserve the deduction is to name a community foundation (a donor advised fund, most likely) as the payor in case the gift conditions are not met by the primary beneficiary.

7. <u>1/11 - **Ralph E. Lerner, John Sare** and **Christine J. Vincent** – Planning and Administering the Artist's Estate and the Artist's Foundation</u>

In an afternoon fundamentals program on planning for artists and their foundations, Mr. Lerner, along with my old friend, John Sare, and Christine Vincent discussed the unique issues of representing artists. Indeed, any of us who have represented artists know that most have very similar issues they face. They often have valuable collections of art (their own and works of friends), but little liquidity. They often face estate taxes in passing their estates to their beneficiaries, but they also lack the funds to pay the taxes (or even the funds to pay the life insurance to pay the taxes).

When it comes to estate planning issues/solutions, the artists as clients also face similar issues: they lack basis in the assets they own, there are severe restrictions on deductions if they try to donate their art, they have a fundamental lack of liquidity and other issues. Taken together, these challenges make planning for the artist unique in many ways. However, again, the consensus of the panel seemed to be: using charitable planning was vital to successfully representing the artist client as well.

In many cases, they suggested, a private foundation (given the types of assets involved, the desire for family involvement, etc) would be a good solution for artist clients. For clients with less valuable estates, community foundations may also be viable alternatives to consider.

8. <u>1/12 – **Goffe** and **Wolven** – Charitable Gift Planning for Unmarried Couples</u>

Not surprisingly, it was suggested that unmarried couples might benefit more than married ones from adding philanthropy into their estate planning. "Unmarried couples" was meant to include unmarried opposite-sex couples, same-sex unmarried or married couples and domestic partners, as focusing on couples without a marital deduction was the primary focus of this session.

The discussion focused on how charitable techniques can be used by unmarried couples including CRTs, CLTs, charitable gift annuities and more.

The panel discussion integrated a series of examples of hypothetical clients to show how certain charitable planning opportunities might add to the family's wealth, reduce taxes and achieve other valuable goals. Beware, they warned, that other outside influences, including unhappy or critical family members could seek to undo

the planning and special care may be needed.

9. 1/12 – **Burns, Bergner** and **Handler** – Planning for the Large Estate of over $15 million – Defined Value Discussion

The panelists presented a series of scenarios and tax planning options for clients in the "medium rich" and "super rich" categories. They concluded by suggesting gifts to grantor/dynasty trusts with defined value clauses should likely be part of any gift tax planning strategy.

As others mentioned during the week, when using defined value clauses the IRS has consistently lost where the excess value passes over to a charity. Burns, Bergner and Handler noted the power of following in the footsteps of these successful decisions – citing to the Petter case. They did suggest, however, that the charity used should perhaps not be the family foundation. The panelists instead stated their preference to name a donor advised fund at a community foundation.

During other presentations this week, it was noted that often community foundations are willing to participate in this type of planning. They often accept interests in family-owned or other closely held businesses. Working with a community foundation may be the best way to follow the defined value formula cases. Plus, they can facilitate an exit strategy (often a buyback by the family or redemption by the business), by avoiding the self-dealing limitations imposed if a private foundation were utilized.

10. 1/13 – **Conrad Teitell** – Charitable Gifts: Annuities and Remainders in Personal Residences and Farms

Due to the very low interest rate environment, Mr. Teitell reminded all that gifts or remainder interests in real property are particularly timely and valuable. The donor receives a present income tax deduction even though the donor retains a life estate (which may be for more than one life). The deduction is based on the remainder value of the residence or farm donated. However, the tables to compute the value of the remainder make it more valuable (and thus the deduction higher) the lower the current AFR is. Since the AFR is now at its lowest point ever, this makes the gift of a remainder more valuable than ever.

He also reminded as to why charitable gift annuities might still make sense for many clients. They are obviously much cheaper and easier to deal with than CRTs. Of

course, they are contracts, so there are lots of variations, including immediate and deferred gift annuities. The timing of the payouts can be tailored to the client's needs (monthly, annual, etc). the amount of the payment, the amount of the deduction and the amount of tax-free returned principal will all vary with interest rates and the gift annuity tables applied (the American Council on Gift Annuities recently updated the rates). Further there was a discussion of the impact of various types of gifted property including mortgaged property and tangible personal property.

I'm sure there were many other charitable mentions during the institute, but obviously and by necessity this summary was just meant to touch on some of the highlights. Also, I wish to note the wonderful and detailed summaries of the Heckerling Institute offered by the ABA-PTL list-serve and available on their website. For sessions I did not attend, I liberally relied on their summaries, and I want to acknowledge and thank the authors.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Baskies

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