

*15th Annual Planned Giving Days
—Washington DC*

*What You See Is Not Necessarily
What You Get*

Washington, DC

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André R. Donikian, J.D.
President
Pentera, Inc.
8650 Commerce Park Place, Suite G
Indianapolis, Indiana 46268

(317) 875-0910
ardonikian@aol.com
www.pentera.com

Case Studies

1. Income Interest in a CRT

In 1995, the chairman of the board of Charity establishes a \$10,000,000 7% annuity trust with zero basis stock. He and his wife, both 55 at that time, are the beneficiaries.

In January of 2006, the Donor, no longer the chair but still a major force at the charity, approaches the president to discuss the annuity trust which is now worth about \$18,000,000, and his net worth is in the \$1,000,000,000 neighborhood.

He had been prowling through the “allied professionals” section of Charity’s P.G. Web site and came across an article on planning with income interests.

In the meantime, Charity was in the throes of developing a plan to approach him for a significant lead gift for the new campaign.

Scenario 1: The Donor and his wife really don’t need the income and wish to assign their annuity interest to Charity.

(a) FMV of annuity trust	\$18,000,000
Present value of annuity interest (\$18,000,000 less \$9,500,000 ch. ded.)	\$8,500,000
Tax-savings at 40%	<u>\$3,400,000</u>

(b) At creation of annuity trust in 1995

FMV of annuity trust	\$10,000,000
Charitable deduction (9% discount rate)	\$2,700,000
Tax-savings at 40%	<u>\$1,080,000</u>

(c) Cash flow since inception of annuity trust

The annuity trust **grew at an average rate of 13% annually** over the 10 years to reach a value of \$18,000,000.

Total before-tax distributions of	\$7,000,000
After-tax value at 40% rate	<u>\$4,200,000</u>

(d) Total benefits (\$3,400,000 plus \$1,080,000 plus \$4,200,000)	<u>\$8,680,000</u>
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(e) Not to mention, capital-gain tax “savings” of	<u>\$2,800,000</u>
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(f) Total “savings”	<u>\$11,480,000</u>
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Scenario 2: Actually, and much to the chagrin of the president and the development staff, the Donor asked the president to have Charity “buy out” their annuity interest. So now, Donors would receive:

a. Results of sale of annuity interest

1. To Donors:

Value of annuity interest	\$8,500,000
Subject to 20% capital-gain tax (Rev. Rul. 72-243, 1972-1 CB 233)	< <u>\$1,700,000</u> >
Net proceeds	<u>\$6,800,000</u>
Plus, benefits 1(b) + (c) + (e)	<u>\$14,880,000</u>

Now, it becomes clear why Donor is worth a billion dollars.

1. To Charity:

Charity receives balance of (\$18,000,000 less \$8,500,000) or	<u>\$9,500,000</u>
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Note: Initial charitable deduction was \$2,700,000

b. Relative value of income interest

1. According to IRS tables, the present value of the annuity stream from the annuity trust is \$8,500,000.

2. However, whether received in installments from the unitrust for life or in a lump sum as sale proceeds, income and capital-gain taxes will have to be paid by the Donors.

3. To the Donors, one of the principal advantages of a lump-sum sale is that the sale locks in the current federal capital-gain tax rate at 15%. Future tax rates are at best uncertain.

Nevertheless, the seller is going to net only 80%, or \$6,800,000.

4. Charity after purchasing the income interest is going to free up the \$9,500,000 locked up in the trust.

(In this case, it would permit Charity to avoid issuing bonds to finance the building project.)

5. Self-Dealing Considerations in Early Terminations

A. Requirements to avoid self dealing for early termination of a CRT

1. Permitted under state law
2. Agreement among trustees and beneficiaries
3. Present value of income and remainder interests calculated using methodology in regulations governing CRTs; no detriment to the charitable remainder person
4. No medical conditions exist that shorten income beneficiary's normal life expectancy
5. Physician and beneficiary have signed statements under penalty of perjury regarding health issue

6. Other reasons to sell income interest in CRTs.

7. The **present value** conundrum

\$1,000 invested at an expected rate of
return of 10% over one year would grow to \$1,100

How much would you pay today for the right to receive \$1,100 at the
end of one year?

Present value for \$1,100	discounted at
(a) \$1,048	5%
(b) \$1,000	10%
(a) \$ 982	12%

See **Selling CRT Lead Interests**, Roger D. Silk and James W. Lintott,
Trusts & Estates, August 2005, p. 37-43, see footnote 9 in particular,
for an excellent explanation of this topic.

Scenario 3: Exchange income interest for a CGA

Considering the ages and wealth of the beneficiaries, this option is probably not attractive to them.

This option may be more appropriate to much older beneficiaries who have become risk averse and concerned about the stability of their income stream.

Scenario 4:

What if this had been a testamentary CRT funded with an IRA with a zero basis?

2. Q. The donor, aged 70, wants to give us \$100,000. But she advised my colleague that she will likely lose her battle with a chronic health problem in the next three to five years—probably the lesser—versus the 17 years remaining life expectancy. So, she wants a payout—over a 3 to 5 year period—that equates as close as possible to the \$110,000 she would receive if she lived the additional 17 years.

I can't imagine that we'd agree to a CGA or CRAT with terms like that. We'd barely break even. Not to mention that the payout rate would be way beyond ACGA guidelines.

Any ideas as to what vehicle might work in this situation and still meet the criteria for a charitable gift?

Is there something else that makes more sense? Should we realistically decline this gift?

- A. Why not suggest a 5% CRAT for life or 17 years—whichever is longer. This way, she'll be assured that the income will be paid for her life expectancy of 17 years. This would not work with a CGA because of the term-of-years aspect.

A CRAT paying \$17,000 a year for 5 years would not work because it fails the 5% probability test.

3. Q. André—Here is the response I received back from the donor explaining where she read this information—any thoughts?

- A. I found that tidbit in “Bob Carlson’s Retirement Watch,” a monthly newsletter. Vol 16, Issue 7, July 2005. The quote is “Charitable contributions are fully deductible under the AMT, except for some contributions of property. Most taxpayers do not have to reduce their charitable giving to avoid the AMT.” This was in an article discussing deductions you cannot claim if you are subject to AMT.

A. AMT Review:

1. **Tax Rate:** 26% on first \$175,000

28% over that

2. **Exemption:** \$58,000 marrieds phase-out over \$150,000

\$40,250 singles phase-out over \$112,500

reduces exemption by \$1 for every \$4 of extra income.

Phase-out stops at \$382,000 and \$273,500 respectively.

3. **Disallowed deductions:**

1. Standard deduction or personal exemptions.

2. Medical expenses 10% of AGI or less.

3. State or local and other taxes.

4. Miscellaneous deductions.

4. Exercise of ISO results in subjecting gain to AMT even if not yet realized.

5. Interest on certain private equity in tax-exempt bonds is taxable.

4. Allaying the Concerns of an Older Donor

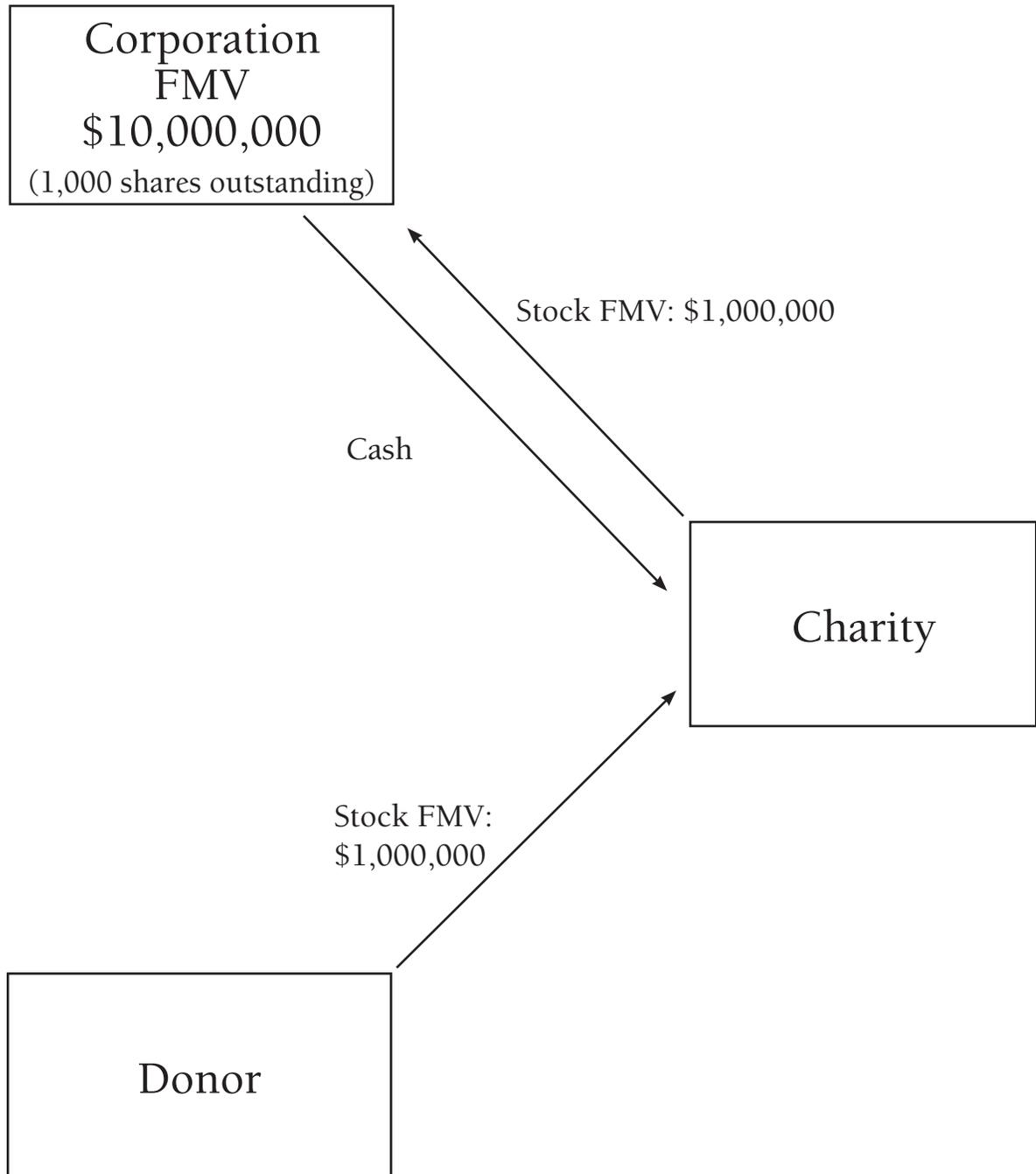
Donor, age 80, has been considering a gift annuity to be funded with appreciated securities worth \$500,000, with a low cost basis. She appreciates all the benefits of this arrangement, (i.e., large charitable deductions, escape from a locked-in position, increased spendable income, lower estate taxes, and recognition of her good work).

Nevertheless, she has one concern that is still holding her back.

Value of transfer	\$500,000	\$500,000
Charitable deduction	\$268,420	\$182,425
Net tax savings (35%)	\$93,947	\$63,849

5. Decedent owned 6.44% in a C corporation whose principal assets consisted of marketable securities valued at \$188,000,000 and a built-in capital-gain tax liability of \$151,000,000 (Est. of Jellee, TC Memo, 2005-131).
- Is the estate's \$12,000,000 interest in C entitled to a discount for the potential capital-gain tax liability?
 - Any other discount available?
 - Impact on charitable bequests.
6. Does the value of a decedent's retirement account—comprised solely of marketable securities—qualify for FET discount to reflect income tax payable by beneficiaries upon receipt of distributions? (Est. of Smith v. U.S., S.D. Tex. 2004), TAM 200247001
- Willing buyer—willing seller test applies to assets and not to account holding assets. FIT paid by seller would not affect buyer's price.
 - IRC §691(c)

7. Planning Opportunities with Gifts of Closely Held Corporate Stock



Donor owns X corp that has a FMV of \$10,000,000 and has been approached by a potential buyer about selling the business. Donor is contemplating a charitable gift of 100 shares of the 1,000 shares that he owns and has a zero basis.

A. Gift of Stock before sale of X

Charitable contribution of 100 shares	\$1,000,000
Minority & lack of marketability discount 30%	< <u>\$ 300,000</u> >
Allowable charitable deduction	\$ 700,000
Net tax savings 35% bracket	<u>\$ 245,000</u>

Donor's gross proceeds from sale of company	\$9,000,000
Capital-gain tax 15%	< <u>\$1,350,000</u> >
After-tax proceeds from sale	\$7,650,000
Plus: tax savings	\$ 245,000
Total after-tax proceeds	<u>\$7,895,000</u>

B. Gift of cash proceeds after sale of X:

• After-sale proceeds to donor from sale of 100 shares	\$ 1,000,000
Attributable capital-gain tax 15%	<\$ <u>150,000</u> >
Net proceeds & charitable gift	\$ 850,000
Net tax savings (35% of \$850,000)	\$ 297,500 vs. \$245,000
	+\$ <u>52,500</u>

Sale proceeds	\$10,000,000
Capital-gain tax	<\$ <u>1,500,000</u> >
Net after tax	\$ 8,500,000
Less: charitable gift	<\$ 850,000>
Plus: tax savings	\$ <u>297,500</u>
Total after-tax proceeds	\$ 7,947,500 vs. 7,895,000
	+\$ 52,500

• If donor feels generous and gives charity	\$ 1,000,000
Net tax savings (35% of \$1,000,000)	\$ 350,000

Sale proceeds	\$10,000,000
Less: capital-gain tax	<\$ <u>1,500,000</u> >
	\$ 8,500,000
Less: charitable gift	<\$ <u>1,000,000</u> >
	\$ 7,500,000
Plus: tax savings	\$ 350,000
Total after-tax proceeds	\$ 7,850,000 vs. 7,895,000
	<\$ <u>45,000</u> >

C. Results to charity:

1. Presale gift of 100 shares to charity

Donor and charity sell shares to buyer and charity receives \$1,000,000

If C corp, end of story, net to charity \$1,000,000

If S corp, UBTI at 34% <\$ 340,000>

Net to charity \$ 660,000

2. Post-sale gift to charity of cash proceeds

\$ 850,000, charity nets \$ 850,000

\$1,000,000, charity nets \$1,000,000

D. Summary of Options

	Gift of stock before sale 100 shares	Gift of net proceeds after sale \$850,000	Gift of gross proceeds after sale \$1,000,000
Donor receives:	\$7,895,000	\$7,947,500 +\$ 52,500	\$7,850,000 <\$ 45,000>
Charity receives:			
S corp	\$ 660,000	\$ 850,000	\$1,000,000
C corp	\$1,000,000?	\$ 850,000 <\$ 150,000>	\$1,000,000 —

8. The Bubble That's About to Burst

Binkley Jones, a 57 year-old investment banker who is doing very well financially, purchased stock less than two years ago for \$18,000. It is now worth over \$600,000.

The president of the company tells Binkley that the stock is grossly overvalued and he cannot understand why it is trading at such levels. **Binkley panics.**

Familiar with gift planning, he asks a favorite charity for a plan that would get rid of his capital gain problem and provide him and his wife with an income stream starting in about 10 years. He is concerned about social security and would like to have a security net for their retirement years.

What options are available?

Solution

The donors elected to transfer the stock now worth \$640,000 to charity in exchange for a 10-year DGA.

Reason: They wanted a fixed, guaranteed stream of income.

As a Result:

Avoided an immediate capital gain tax of (\$640,000 - \$18,000) x 15%		\$93,300
A Charitable Income Tax Deduction of	\$288,909	
Saves them up to (35% income tax bracket)		<u>\$101,118</u>
Total tax savings		<u>\$194,418</u>

After 10 Years

A guaranteed annual annuity of		\$ 60,160
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At their deaths

\$640,000 has been removed from their estates

9. Give Bonds to Capture Gain, Eliminate Risk

- a. As interest rates have dropped, the value of corporate and government bonds that pay higher than current market rates has increased. Investors who purchased bonds a few years back often have seen the value of those bonds go up significantly. Now, though, bondholders may feel as if they are sitting on a time bomb with three fuses.

First, some of these bonds may be subject to provisions that allow the bond issuers to call in such bonds at par (face value).

Second, even if the bonds are not called, they will only be worth their face value if held until maturity.

Further, if interest rates start to rise, investors will see their appreciation begin to melt away.

Thus, to capture the benefit of the appreciation, the owner has to sell the bond, which in turn will trigger the capital-gain tax.

For these reasons, appreciated bonds can be an excellent choice to fund charitable gifts.

b. Calculating Value of Bonds

In 1984, an investor bought a newly issued \$100,000 par value 30-year U.S. Treasury Bond with a coupon yield of 12.4% paid out semi-annually. The bond will mature in 2014. In 2006, the yield to maturity (YTM) on a comparable bond is currently at 4.975%. It reached a low of about 3% in June 2003.

Cost basis in 1984	\$100,000
Current (8/2/06) value at 4.975% YTM	\$148,038
Value at 3% YTM (in July 2003)	\$194,143
In 8 years the bond will be redeemed for	\$100,000

Calculator Method

Enter:

FV \$100,000

I $\frac{1}{2}$ of interest rate

N Number of semi-annual payments

PMT Amount of semi-annual payment

Then:

punch CPT, and PV

c. Outright gift option

FMV of 4.975% YTM bond	\$148,038
Tax savings in 35% bracket	\$ 51,815
Capital-gain tax avoided (\$48,038 x 15%)	<u>\$ 7,205</u>
Total taxes avoided	\$ 59,020

d. Give Bonds...cont.: Gift Annuity

1. Life-Income Option

An 80-year-old who owns such a bond now valued at \$148,038 would be receiving \$12,400 annually over the next 8 years.

No gift

Annual return	\$12,400
Tax at 35%	<\$ 4,340>
After-tax return	\$ 8,060

2. Gift Annuity for \$148,038

a. Annual annuity			\$11,843
Tax-free portion	\$5,112	net	\$ 5,112
Capital gain	\$2,456	net	\$ 2,088
Ordinary income	\$4,275	net	<u>\$ 2,779</u>
After-tax return for 9.4 years			<u>\$ 9,979</u>
Thereafter, after-tax return			<u>\$ 7,698</u>
b. Charitable deduction			\$76,875
Tax savings at 35%			\$26,906
Net return at 6% and after blended 20% tax rate			<u>\$ 1,292</u>
Total annual return for 9.4 yrs (\$9,979 + \$1,292)			<u>\$11,271</u> + 40%
Thereafter (\$7,698 + \$1,292)			<u>\$ 8,990</u> + 17%

e. All That Glitters

Donor has owned 740 South African Krugerrand gold coins for more than one year that he proposes to transfer to a CRUT.

In Rev. Rul. 69-63, 1969-1 C.B. 63, the IRS ruled that a collection of rare coins held as collector's items is tangible personal property. The ruling also ruled that cash is not tangible personal property within the meaning of the statute.

The IRS determined South African Krugerrand gold coins are more akin to money than to coins that have value as collector's items. They are one of the best known types of gold bullion coins; and they have no numismatic value. Also, the trustee is authorized to dispose of the coins. Therefore, pursuant to the rationale of Rev. Rul. 69-63, the IRS concluded that the South African Krugerrand gold coins are not tangible personal property within the meaning of IRC §170(a)(3).

Gold Prices

2002	\$283.10	1986	\$390.90	1970	\$ 38.90
2001	\$271.04	1985	\$327.00	1969	\$ 41.00
2000	\$279.11	1984	\$309.00	1968	\$ 43.50
1999	\$290.25	1983	\$380.00	1967	\$ 35.50
1998	\$288.70	1982	\$447.00	1966	\$ 35.40
1997	\$287.05	1981	\$400.00	1965	\$ 35.50
1996	\$369.00	1980	\$594.90	1964	\$ 35.35
1995	\$387.00	1979	\$459.00	1963	\$ 35.25
1994	\$383.25	1978	\$208.10	1962	\$ 35.35
1993	\$391.75	1977	\$161.10	1961	\$ 35.50
1992	\$333.00	1976	\$133.77	1960	\$ 36.50
1991	\$353.15	1975	\$139.29	1959	\$ 35.25
1990	\$386.20	1974	\$183.77	1958	\$ 35.25
1989	\$401.00	1973	\$106.48	1957	\$ 35.25
1988	\$410.15	1972	\$ 63.84	1956	\$ 35.20
1987	\$486.50	1971	\$ 44.60	1955	\$ 35.15

10. Eight and Eight Leverage Plan

“ DePauw University is pleased to feature a leveraged gift plan, specifically designed for individuals who may be interested in taking advantage of one of the available naming opportunities during the Capital Campaign. The **Eight and Eight** plan enables a donor to make a significant contribution to fund a chair at a relatively modest out-of-pocket cost.

Here is how it works:

Donor contributes \$1,000,000 of highly appreciated assets to a charitable remainder unitrust that will distribute 8% of its annual value each year to him or her for a period of eight years after which the trust assets will be distributed to DePauw. Assuming the trust assets grow at 10% per year and the donor’s basis in the assets is \$200,000, the following results may be anticipated:

Transfer to unitrust		\$1,000,000
Charitable deduction		\$ 525,670
Tax savings at 39.6%	\$208,165	
Total distribution to Donor over 8 years		\$ 686,638
After-tax benefit	\$567,447	
Estate tax savings*	<u>\$123,413</u>	
Total value of benefits	\$899,025	\$ 899,025
Out-of-pocket cost of gift		<u>\$ 100,975</u>
DePauw University receives after 8 years		\$1,171,659

* Even though the value of the unitrust is removed from the estate, the income-tax savings of \$208,165 and the after-tax distributions of \$567,447 are now part of the estate. So the net amount removed is \$1,000,000 less \$208,165 less \$567,447 or \$224,388 and the estate tax savings is 55% of that amount or \$123,413.

11. Donor in her 80s created a \$75,000 CGA in May, and another one for \$25,000 in June with Mega charity. She died in November. Her remaining estate valued at \$98,000 was also bequeathed to Mega charity. Nursing home where she lived and died asks Mega charity to give it the \$98,000 bequest on grounds that she had promised that portion to nursing home. Mega turns over its interest to nursing home.

Issues 1.

2.

3.

15. Re: Family Limited Partnership

Dear Sister O'Hara:

I am the attorney for _____. As you are aware, in 1996 _____ transferred to the Sister of Providence a 1% Class A Limited Partnership interest in the _____ Family Limited Partnership. As a Class A Limited partner, the Sisters receive \$1,558.97 from the partnership annually. _____ now wishes to cash out the Sisters from the partnership. However, she cannot remove the Sisters as a partner without dissolving the partnership. On the other hand, if the Sisters were to withdraw as a partner, the expense and delay of dissolving and reforming the partnership may be avoided. If the Sisters withdraw, they will receive the same amount to which they would have been entitled if the partnership dissolved. This amount has been calculated on the enclosed Withdrawal to be \$28,345.71.

Accordingly, I request that you please execute the enclosed original Withdrawal and return it to me. Upon receipt of the original Withdrawal, the partnership will send the Sisters of Providence a check in the amount of \$28,345.71. If you have any questions on the contents of this letter or the enclosed withdrawal, please do not hesitate to contact me.

Sincerely,

16. Widow, 80, is moving from Indianapolis to Bloomington and wants to make a gift of her home to local charity in accordance with her deceased husband's wishes who died 10 years ago. She and her husband were actively involved with the charity.

Any Suggestions on structuring the gift?

17. Donor contributes Anthem, Inc. worth \$92,000 (cost basis of \$56,000) to charity for a gift annuity. Charity issues an agreement and a cover letter spelling out specifics and stating that Donor is entitled to a \$28,000 charitable deduction.

Problem: