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TAX AND PRACTICAL CONSIDERTIONS FROM A CLIENT'S PERSPECTIVE – TEN MAJOR THEMES FROM ONE LAWYER'S RECENT EXPERIENCE

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I. Background

While there are many factors in a client's thoughts about charitable giving as part of the estate planning process, the impact of estate taxes on the overall plan should not be underestimated. Clients are well aware that there has been a dramatic increase in the Estate Tax Exemption and yet many states have capped their exemptions at a lower amount.

It is likely this exemption will increase and the tax rate, which is currently at 45% for Federal Estate tax alone, will presumably decrease but there are no assurances. The laws are very unclear on both the local and Federal levels. Uncertainty is something that clients have become only too familiar with in their estate planning.

Acknowledgement must be given that charitable giving is still not common in most clients' plans and mind sets. Yet, the foregoing means that about half of the total assets above the exemptions will be paid to the governments in Estate Taxes.

There is also some recognition of the "Warren Buffett thinking" that maybe our legacies are not just to maximize what we can give in assets to our children and grandchildren, Charitable giving is becoming an increasingly more important part of the clients thought process.

One approach that a few clients have recently implemented is to leave a significant portion (such as an amount equal to the Federal estate exemption) to family members or other individuals. The amount in excess of the Federal exemption is then left to one or more charity(ies) as part of one's Will and other estate planning documents (such as a Revocable Trust, and IRA/Plan and Life Insurance Beneficiary Designations) .

Another important factor is that clients want flexibility in their estate plans to permit future changes in circumstances for many of the following reasons:

A. Likely changes in the Estate Taxes
B. Changes in health and economic needs over the coming years
C. Likely changes in family structure and members
D. Potential changes in other family members' needs
E. Unknowns about future desire to make gifts
F. Current and future involvement in charities
G. Mobility considerations

With this background in mind, set forth below are some of the recent considerations that impact charitable planning – both from a legal and practical perspective that this lawyer is increasingly facing at client meetings.

II. Ten Major Themes

A. Involving Charity as Part of the Estate Planning Process.

Discussions at client meetings still focus primarily on the family or other desired individual beneficiaries. What is the lawyer's role in encouraging charity in light of all the factors shown above? Lawyers now have a much higher level of ethical and conflict of interest rules to follow and have become extraordinarily careful about overstepping. For example, if the attorney is providing assistance to a charity in some capacity, may such attorney also prepare estate planning documents for a client that benefits such charity? Clearly, and at a minimum, disclosure of such dual roles is required and such disclosure should ideally be in writing. (As the saying goes: "Where there is a Will, there is a relative.")

In addition to the ethical issues, there are numerous ways to provide for both the family and the charities while also allowing for future unknowns. For example, note the following options as examples:

1. Provide a specified percentage of the estate to charity, which inherently has an "inflation factor for the future.
2. State a dollar limit on what goes to charity with or without a CPI adjustment.
3. Limiting the charity's benefits to contingent events,
4. Focusing on tax benefits by leaving income in respect of a decedent ("IRD") type assets to charity as noted below.

Discuss goals and long term desires since lawyers are advisors and confidants. Care must be taken to giving meaningful long-term options and making sure the client is heard and will then be less likely to have second thoughts later.

B. Endowment Mindset

When substantial transfers are made, a larger percentage of clients want to make sure that some form of legacy in memory of the client or the client's family is also ensured. The consideration of sufficient funds to create an endowment such as to "chair" a position or have certain annual events made available through the income generated from the corpus is very attractive.

Clearly many programs of the deferred giving professionals have shifted to this acknowledgement and increased publicity confirms this direction ("Living Legacy" concept).

What assurances does the client have that the money will be used in a perpetual manner for the goals the client has stated? What are the vehicles to provide assurances? Will the family continue to be acknowledged when the income is given out and proper recognition given?

C. Family Foundations.

Private Foundations are still very popular and clients like the goals about the involvement of the family in charitable giving and that the entity will carry on after their demise. The potential for salaried positions in the future may also be a valuable feature.

Many clients have determined that such a Foundation should be set up under their Will or Living Trust. Naturally the Foundation could also be set up during life under the IRS Form 1023 process. For the wealthy client, he/she generally perceives that a private foundation leaves more control within the family notwithstanding all the restrictions, payout requirements and limited taxes.

An increasingly popular tool in the charitable giving arena is the utilization of donor advised funds. In light of the trend enhanced by the incredible success of the Fidelity Charitable Gift Fund. Numerous financial entities and charities now also offer this alternative.

While the Donor Advised Fund is a much cheaper way to both establish and maintain a Foundation without the usual restrictions since it is a public charity, the advantages and disadvantages are not always understood by the client. One downside is the amount of internal fees incurred.

From my experience, clients initially were concerned whether their desires and the family's involvement would be preserved. They understood it was to a public charity but it felt removed and they worried that the goal of having a "Foundation" might be lost. For these reasons, many still wanted to set up a Private Foundation. These concerns seems to have died down especially for the clients who do not want to establish the Private Foundation with the typical larger minimum sums assumed for such an entity (e.g., $1.000,000, although the amount for an appropriate minimum varies by advisor).

D. Lifetime Transfer of IRA Funds to Charity in 2006 and 2007.

For last year and this year, up to $100,000 in one year can be transferred by an individual who is 70-1/2 or over. There is some uncertainty about whether this will be extended.

While not directly related to deferred giving, the ripple effects of this rule on deferred giving are important. First, Congress is finally beginning to permit the lifetime giving directly of qualified assets to charity without having to take the assets into income first. (Benefits of this process include such advantages as not impacting the phase-out of miscellaneous deductions and not increasing the alternative minimum tax.) Similar bills in past years were introduced, but there is now hope that this opportunity for lifetime giving from an IRA or a qualified plan will be expanded.

A second ripple effect is the message about donor advised funds as noted in II C. above. Congress limited the transfer of these IRA proceeds in that split-interest trusts and donor advised funds are not permissible beneficiaries. Is the message here that donor advised funds are now on the watch list? Many feel that more restrictions will soon be imposed on donor advised funds and how they are administered.

E. Designation of Charity of IRA/Plan Upon Death.

The manner in which IRA proceeds or qualified plan assets are transferred to charity upon death must be reviewed carefully. If these IRD assets are used to satisfy the "pecuniary" bequest of an estate or the pecuniary distribution from a trust, then the estate or trust may have accelerated taxable income to itself on the distribution since it is satisfying an obligation of such estate or trust.

This proposition was recently reinforced in an IRS Chief Counsel Memorandum concerning Section 691(a)(2) of the Internal Revenue Code. The ruling dealt with assets payable to a trust and then the Trustee paid the IRA proceeds to the charities. There is some argument that this is limited to an estate or trust making the payment rather than from the Custodian directly.

If IRA or qualified plan assets will be used to pay a definite amount to a charity, a conservative position is to have a specified amount from the estate, trust or IRA stated in a “fractional” method. (As noted above, the literal reading of the applicable section of the Code, however, suggests this is only applicable to a trust or estate.) For example, a designation could be stated in the following manner and avoid this issue. “Upon my death, such fraction of my IRA shall be paid to the XYZ charity based on the value of my account at the time of my death times a fraction in which the numerator is $150,000 and the denominator is the value of my account at the time of my death.”

This fractional method should avoid the argument that a pecuniary amount was used even though the result is the same.

F. <u>Use of a Charitable Remainder Trust</u>.

The establishment and utilization of a charitable remainder trust (primarily referring to a CRUT or a CRAT, but collectively or individually a “CRT”) tends to have better tax results when the applicable Section 7520 rates under the Internal Revenue Code are higher rather than the current low rates. While under this current low interest environment, the use of such Trusts is less widespread, there are still several reasons that they are being implemented.

One of the obvious benefits is that the transfer of highly appreciated assets to a CRT will not accelerate the inherent capital gains. Even with the low current capital gains rate at the Federal level, this can still be a powerful tool especially when the donor is in a state that imposes income taxes. The second benefit commonly noted is the income tax deduction for the present value of the remainder interest passing to charity following the beneficiary(ies)' interest.

There are two other advantages, among others, entailed with the implementation of a CRT. First, unless there are hard to value assets, presumably the donor could also be a Trustee. The degree to which each client wants to retain control on his/her planning documents should generally be considered and the ability to be a Trustee is often very important. Second, the ability to change or reallocate the interests of the charity(ies) after the term on the life (lives) of the individuals whether by a lifetime or testamentary documents is often an important desire for many clients. Naturally, the charity would like to be a Trustee and this is often preferred once the client realizes the administrative burdens and hassles.

Another situation that lends itself to the use of a CRT is in the second marriage situation. The marital deduction protects the transfer of IRA proceeds to a CRT Trust which provides benefits for the surviving spouse and then passes to charity to minimize Estate Taxes and carry out goals of the client. Since the CRT is a tax exempt trust, it appears the distribution(s) are available to serve these purposes and is therefore often a good choice for the right situation.

G. <u>New Unrelated Business Taxable Income Provisions for a CRT</u>.

There has been extensive commentary about the change in impact if there is unrelated business taxable income ("UBTI") in a CRT, as a result of the Tax Relief and Health Care Act of 2006. As noted above, a CRT is generally exempt from income taxes. However, if there was UBTI in a year before 2007, then under the Internal Revenue Code, the entire CRT was treated as a complex taxable trust for income tax purposes.

Beginning in 2007, the receipt of UBTI does not destroy the tax exempt nature of the whole CRT. Rather, the portion that is UBTI will be subject to a 100% tax. For example, some donors want to give partnership or LLC interests to a charity. However, if the partnership then invests in real estate which is debt-financed, there well may be UBTI.

Under the foregoing example, the good news is that the other income of the CRT is not deemed to be taxable. The bad news is that the 100% tax on the UBTI portion actually understates the impact of the tax impact. In addition to the full 100% tax, the beneficiary under the CRT layering of income tax rules is likely also taxed to some degree on such income when it is paid out. Further, there may also be state tax implications beyond the foregoing taxes.

H. Use of a Charitable Lead Trust.

As noted above, the CRT tends to work better for the client's purposes when interest rates are higher. The corollary is that in this current environment of continuing low interest rates under Section 7520 of the Internal Revenue Code, the charitable lead trust (primarily a charitable lead annuity trust or a charitable lead unitrust but together or individually a "CLT") produces better results for gift and estate taxes. More specifically, the locking in of the annual amount to charity in the charitable lead annuity trust results in its selection more often than a charitable lead antirust. (On the other hand, the charitable remainder unitrust is generally a more popular choice than a charitable remainder annuity trust.)

The general thinking for most planners in this situation is that assets will grow or earn income at a higher rate than the IRS rate at the time the CLT is established. The “excess” that is not paid out to the charity will then build up and benefit the remaindermen (usually younger generation family members). Unlike the CRT, the income taxes have traditionally been less of a factor than the gift and estate tax benefits. Naturally, there are other non-tax benefits such as assurance that specific charity(ies) will be benefited (possibly even the family foundation) and potential greater involvement of the family.

The CLT must be structured as a “Grantor” or “Non-Grantor” Trust. Until recently, most CLT’s were structured in a Non-Grantor fashion in which the upfront deduction for income tax purposes was not available. However, recent changes in the tax law have made Grantor Trusts more popular as of late. In the Grantor Trust, the deduction is available up-front but then during the term of the charitable payouts, the income of the CLT is included in the donor’s taxable income each year.

The benefit of this Grantor Trust because of these new tax developments is that if the donor transfers assets to a CLT in a year in which he/she has large ordinary income such as compensation, the present value of the charitable deduction offsets at least some of that ordinary income. If the assets generated are invested in such a manner that they produce capital gains or qualified dividends that are taxed at a much lower level, the CLT may also provide great income tax advantages. The difference in the ordinary income rates as opposed to the qualified dividend or capital gain rate of generally 20% cannot be underestimated.

Planners in this area are still awaiting the suggested IRS forms for CLT's that have long been .available for CRT's. They will presumably be available soon.

One other recent development for planned giving directors has arisen on how a CRT and a CLT in treated if they invest in endowment contracts. A series of IRS rulings appear to permit a CRT to invest in contract rights in an endowment such as Harvard's but not a CLT.

I. Appraisers as Targets of New Tax Law.

Clearly assets that do not have a publicly traded market need an appraisal by an individual qualified to make such determination. Under the recently enacted Pension Protection Act, additional penalties were expanded in the income, gift and estate tax laws when an appraisal is deemed to be substantially or grossly understated.

The penalties are of some concern because this may increase the cost of doing business by the appraisers. What is of greater concern to the appraisers is that essentially the appraisers could be blacklisted by the IRS. It appears that a reasonable defense, such as the appraiser having relied on facts provided by the taxpayer that are later proved to be false does not prevent the appraiser from being blacklisted. Such blacklist means the ignoring of such appraiser's work by the IRS. Such result therefore impacts not only the justification to back up the value for a charitable deduction may result in the appraiser being somewhat more conservative in his/her valuation. This latter result is naturally a goal of the IRS.

Appraisals may also end up charging more for their services because of these ramifications.

J. Life Insurance Proceeds for Charity.

The beneficiary designation of life insurance proceeds to a charity has long been considered a good vehicle to provide a material gift to charity upon the donor's death. Naturally, while the payment of the proceeds is a charitable deduction for Estate Tax purposes, the donor usually wants additional tax advantages.

Arranging for the charity to own the policy in lieu of the donor also provides an easy way for the annual contribution sufficient to cover the premiums to be deductible. Making sure that the charity owns all rights and incidents of ownership in the policy is also vital. The disadvantage to such ownership is that donors often want to retain the ability to name another charity for part or all of the proceeds. If the income deduction is important, then for income tax substantiation purposes, in lieu of the donor paying the premium directly, the better route is to have the payment made to the charity which then turns around and pays the premium.

Arrangements involving charitable split dollar, situations in which the charity will own the policy for a limited time ("CHOLI"), investor owned life insurance ("IOLI"), premium financed insurance, and other charitable situations in which the intent is for the charity to only have a limited interest must be carefully scrutinized. For reasons involving the retention of personal benefits by the donor and state laws covering insurable interest rules, these schemes may result in severe adverse tax and potentially legal consequences. Specifically, the IRS and state regulatory authorities have these types of alternatives on their radar screens.

The foregoing arrangements bring in to question whether the charity has an insurable interest in the insured. The state laws surrounding these provisions are enforced not only to make sure life insurance is not a security, but so that the anti-gaming laws are not violated. The primary question about insurable interest is to make sure there is an economic interest by the owner of the policy on another. Charities usually have greater protection under the applicable state laws and less inherent scrutiny than ownership of the policy by “Big Louie”, but care should be taken to satisfy the spirit of these rules.

Accordingly, if life insurance will be owned by a charity on a donor, certain steps should be followed. As part of the written arrangement by which the charity’s ownership of a policy will be either established or a donor will transfer such a policy to the charity, document should provide that the insured had sufficient notice of this arrangement and the policy is subject to the donor’s consent.