Denver Estate Planning Council

11 Lessons from 35 years of Charitable Planning

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When I started practicing over 35 years ago in a small CPA office in Ft. Collins, Colorado, I had no idea that I would have the opportunity to work with hundreds of philanthropists in fulfilling their visions of how they want to change the world. Along the way, I've learned a few lessons: here they are for education, enlightenment, or wry recognition of some universal truths of charitable planning.

1. The donor's charitable intent determines whether a gift is made or not. Tax benefits, however, influence what is given, when, and how, to fulfill that intent. The professional rarely has influence over the type of charity the donor supports, but has great opportunities to make that support more effective through his or her knowledge and advice.

The Internal Revenue Code contains various incentives for charitable giving. In addition to offsetting taxable income, the donor can avoid tax on the gain inherent in appreciated capital assets by transferring those assets to charity. However, the income tax rates have never been in excess of 100%, so even the most tax-favored deduction results in the diminution of the donor's wealth.

Not all assets produce the same tax benefits, so well-advised donors plan their donations before they make them. A donor wants to transfer $100,000 to a charitable remainder trust (CRT). The remainder beneficiary is her alma mater. The value of her retained interest in the trust is 60%. Which of the following assets would make the best donation—and why?

a. Publicly traded stock held for six months worth $100,000. Basis is $40,000.
b. Publicly traded stock held for 18 months worth $100,000. Basis is $130,000.
c. Baseball card collection that could be auctioned off for at least $100,000. Basis is $1,000.
d. Closely held stock worth $100,000. Basis is $60,000. Corporation does not have a Subchapter S election in place.
e. Partnership interest worth a net of $100,000. Partner's share of partnership debt is $150,000.

The best answer is (d), the closely held stock. Although an appraisal will be required,[1] a deduction is available for the fair value of the stock, reduced by the value of her retained interest in the charitable remainder trust. Answer (a) is not good because the donation deduction will be limited to the lower of fair market value or basis because the property is short-term capital gain property.[2] Answer (b) is not good because a donation is not a sale or exchange which would allow the loss to be recognized. So, although her charitable deduction is 40% of $100,000, the $30,000 built-in loss can never be deducted. If that's the asset she wants to dispose of, she should sell the stock, deduct the capital loss, and donate cash to the trust.

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[1] Treas. Reg. Sec. 1.170A-13
[2] Sec. 170(e)(1)(A)

The baseball card collection has two problems as a potential donation. First, donations of tangible personal property are only deductible at basis unless the charity uses the donated property in its charitable function (think paintings to museums)[3]. If the property is not used by the donee for at least three years, a recapture tax will be imposed on the donor.[4] Since a charitable remainder trust is unlikely to have a charitable function, the baseball cards would never qualify under this criterion. Second, there is another potential problem with donations of tangible personal property to charitable remainder trusts. Such trusts are split interest trusts, with the non-charitable lead interest treated as a retained interest. Charitable donations of tangible personal property are not deductible until all the retained interests have expired or been relinquished.[5] This limitation could be avoided by having the trustee of the CRT sell the cards before the end of the year in which the donation is made.[6] The problem with this technique is that if the property doesn't sell before year-end, the deduction is lost for that year.

The partnership interest also raises two problems. A charitable contribution of a partnership interest is subject to the bargain sale rules of Section 1011(b) if the partnership has liabilities and the donor's share of partnership liabilities is less than the fair market value of the partnership interest.[7] These rules cause the donor to recognize gain. Our donor would be treated as realizing $150,000 of deemed proceeds (the amount of her allocated debt from the partnership). Most of the deemed proceeds would be taxable gain, which was probably what she was trying to avoid by the donation.[8] In addition to recognizing the gain, there is a risk of a penalty on the donor as well. CRTs are subject to some of the penalty rules applicable to private foundations.[9] Among the acts subject to penalties are sales between a donor and a CRT, even if that transaction is an indirect sale caused by a bargain sale.[10] Generally, an initial donation to a CRT would be excepted from that penalty, but debt-burdened donations should be approached with extreme caution. However, the eventual sale of the partnership interest, or the underlying partnership property, may well give rise to a 100% tax under the unrelated business income tax rules.[11] Obviously, that should be avoided.

Occasionally, an outright donation of a partnership interest works out well, even with some debt. Consider a donor with a partnership interest worth $700,000, where the donor's share of partnership liabilities is $200,000. Assume his capital account is only

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[3] Sec. 170(e)(1)(B)(i)(I)
[4] Sec. 170(e)(7), which also provides for exceptions to recapture if the charity attempts unsuccessfully to use the property.
[5] Treas. Reg. Sec. 1.170A-5(b) Ex. (6)
[6] PLR 9452026
[7] If the debt is equal to, or greater than, the gross value of the partnership interest, then the general rules of §1.1001-2 apply because there will be no charitable deduction. But there still will be a taxable gain.
[8] See Rev. Rul. 75-194, 1975-1 C.B. 80; *Maxine Goodman*, 2000-1 USTC ¶50,162; and PLR 9533014 for details of the gain calculation
[9] Sec. 4947(a)(2)
[10] Reg. Secs. 53.4941(d)-1(a) and 53.4941(d)-2(a)(1)
[11] Sec. 664(c)(2)

$70,000. His gain is $180,000[12], but he is entitled to a donation deduction for the net value of $500,000, which more than offsets the taxable gain.

It is also possible that the donation deduction really doesn't matter to the donor. This is often true when a donor funds a CRT and retains an interest equal to the maximum 90% of the value of the property contributed.[13] In that case, the selection of the asset may be more driven by the taxable gain to be avoided, rather than the deduction to be gained. In this case, item (a), the short-term stock, or (c), the baseball cards, might still be a good fit.

Before leaving the analysis of "which asset is best," we should address the current increased tax rate environment. As we move into the increased top marginal rate environment with the highest capital gain rate increasing to 20%, the effect of the 3.8% net investment income tax, and the return of various phase-outs and reductions of the benefits of itemized deductions, start to erode the benefit of the charitable itemized deduction. Those changes put more of a premium on excluding income from Adjusted Gross Income (AGI) than on generating a tax deduction. Not to get too deeply into the statistical analysis, but initial calculations indicate that the benefit of donating appreciated property, vs. a "sell and donate the proceeds" strategy, only improve under the tax law as currently written.

2. Know the donor's personality and history. No matter how good a fit there seems to be with all the puzzle pieces—the potential donor, charity, asset, and technique—a donor's personality traits and habits can disrupt the best-laid plan.

If the donor will not relinquish control, follow directions, or play by the rules, then the professional should use caution in recommending a CRT, charitable lead trust, private foundation, conservation easement, supporting organization, or other structured donation that requires strict adherence to form to obtain the benefits.

If your donor frequently forgets to make his estimated payments on time, writes personal checks from his business account, and otherwise treats all funds as fungible, he will probably continue such habits when he has a private foundation or charitable trust. Writing a personal check from the business account is an annoyance, not a disaster[14]. But writing a personal check from a charitable entity can subject a taxpayer to penalties for self-dealing[15] and taxable expenditures.[16] In addition to the monetary penalties (and, of course, replacing the funds), the donor's failings are visible to everyone, including the media, through the returns available at Guidestar.org. Repeated disregard of the rules can lead to disqualification of the charitable entity itself, and loss of all tax benefits.[17]

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[12] Reg. Sec. 1.1011-2: gross proceeds equal to debt of $200,000: less allocated basis of $20,000 (70,000 x (200,000/(200,000 debt + 500,000 equity)).).
[13] Secs. 664(d)(1)(D), 664(d)(2)(D)
[14] See Zavadil v. Commissioner, T.C. Memo 2013-222 (TC 2013)
[15] 10% Sec. 4941(a)(1) plus 5% Sec. 4941(a)(2)
[16] 20% Sec. 4945(a)(1) plus 5% Sec. 4945(a)(2)
[17] Atkinson v. Comm. 115 T.C. 26 (2000), affd. 309 F.3d 1290 (11th Cir. 2002)

Does this mean your headstrong or disorganized donor is precluded from charitable donations? No. But he or she might be better served by a donor-advised fund than a private foundation. In addition to the increased tax benefits of a donor-advised fund,[18] the record-keeping is minimal, and the risk of a financial accident is almost nil. If his philanthropic and tax motivations are such that a charitable trust would be appropriate, then perhaps he should not be the trustee (or the sole trustee). If she wants some income back from her donation, consider a charitable gift annuity instead of a CRT, especially if the amount is relatively small.

If your donor's inattention to detail is the source of the problem, a good bookkeeper or a co-trustee with control of the checkbook may be all that is needed to avoid problems. But if his vice is serial entrepreneurship or cross-collateralizing real estate-- always needing funds for the next big venture, it is probably wiser to implement techniques that make the funds completely unavailable, such as using a commercial or charitable trustee for a charitable trust.

3. If a potential donor asks about the tax benefits before expressing any charitable intent, he is probably trying to donate his way out of a bad investment.

It is one of the fundamentals of tax law that a donation (charitable or personal) is not a "sale or exchange" that would allow a loss to be realized. So, if someone has a losing stock in their portfolio, the most tax-effective transaction is to sell the stock, recognize the capital loss, and donate the cash proceeds.

However, if the "asset" that they're sitting on is a partnership interest with a negative capital account (generally due to the partner having been able to deduct losses in excess of his investment due to allocations of "qualified debt"), then a sale of the partnership interest or the partnership's assets would generally result in a significant taxable gain and insignificant or no cash. The "donor" then has the idea that if he gives the partnership to charity, he will be off the hook for the tax consequences of the sale. Unfortunately, the tax rules look through the partnership, and treat the partner's share of the debt as proceeds from a sale[19] because the donation relieves him of the debt. So the phantom gain is taxed to him anyway.[20] The results are the same whether the debt is recourse or non-recourse.[21] This is probably not what he had in mind. Unfortunately, there's no inexpensive way out of this situation.

4. At least 10 percent of your time as a charitable planner will be devoted to explaining why the advice or ideas he got from his buddies or the media is either wrong or inapplicable to his situation.

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[18] Defined in Sec. 4966, and available at community foundations, commercially affiliated foundations, and other charities.
[19] Sec. 1.1001-2(a)(2)
[20] See PLR 201012050
[21] Sec. 1.1001-2(a)(4) and Ebben v. Commissioner, 783 F.2d 906 (9th Cir. 1986)

This problem is not limited to charitable planning, but certainly charitable planning has its share of free advice that's worth what was paid for it. For example, just because his golfing buddy says that our donor can deduct the value of the week at his beach house that he donated to the charity auction doesn't make it deductible. Notwithstanding the value put on the receipt by the donee charity, giving a charity the right to use property, for an auction or any other purpose, is simply not deductible.[22]

Speaking of auction donations, since the donated property will not be used by the charity in its exempt function, the donation deduction is limited to the lower of cost or fair value.[23] Even if one donor's bridge partner deducted the value of a painting given to a museum for display, your donor cannot deduct the value of a similar painting donated to the museum for their annual auction. If the deduction is more than $5,000, the donor must have a qualified appraisal and a completed Form 8283—even if the value of the painting is $30,000 and the deduction is limited to her $8,000 cost.[24] Given the cost of art appraisals, her donation may not net her any benefit after expenses. The obvious solution here is for potential donors to understand the rules before they make the donations so that they are not surprised by their CPAs the following April. If the goal is a tax deduction, then the donor needs to select a charity that will be able to use the donated tangible property in their mission. If the goal is to provide an auction item, then perhaps she should choose an item with a deductible cost basis nearer to the value of the piece, to justify the cost of the appraisal.

5. There is always another scheme or scam around the corner, just waiting to take advantage of donors' generosity and the complexity of the tax code. Remember, the general rule of life "if it sounds too good to be true, it probably is" applies to charitable planning.

Probably no further proof of this is needed than reviewing the IRS list of "Listed Abusive Tax Shelters and Transactions" and "Transactions of Interest."[25] Without going into the details of how each of the listed transactions was purported to work, the common element of the "charitable" items on these lists is an attempt to achieve a charitable income tax deduction without the equivalent transfer of value to the charity. Section 170(f)(10) was added to the Code to preclude the transaction commonly known as "charitable split dollar." The idea was an insurance arrangement that created a deduction in excess of the net value transferred to the charity. The charitable lead trust regulations[26] were changed in 2001 to preclude the use of unrelated, but sickly, people as measuring lives for the trust term (the so-called "vulture trust" technique). Whether any of these were actually executed has been questioned, but the intent of the technique was to obtain a charitable gift tax deduction in excess of any possible distribution to charity. Treasury released

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[22] Reg. Sec. 1.170A-7(d) Ex. 1
[23] Sec. 170(e)(1)(B)(i)(I)
[24] Sec. 170(f)(11)(C)
[25] www.irs.gov
[26] Reg. Secs. 1.170A-6(c)(2)(i)(A) and -6(c)(2)(ii)(A)

proposed regulations[27] to deal with a potential basis creating transaction involving the full disposition of an interest in a charitable remainder trust.

6. A confused donor is not a happy donor. If a donor doesn't understand what he's getting into, either he won't sign up or he'll be mad at you later. Or his heirs will be mad at you. Either way, it's not a good idea to leave a client/donor with less than a clear understanding of the alternatives and the consequences.

Sometimes, it is possible to reform a charitable transaction that fails to meet the clients' goals, even when the failure is discovered after execution. See PLR 9816030, in which the court and the IRS allowed the settlor of a CRT to rescind the trust on the basis that she had not understood that the trust could not be invaded (in this case, for medical expenses). However, it is clear from the ruling that the rescission followed expensive litigation and the cost of obtaining a ruling. The ruling archive is replete with charitable trust reformations due to scrivener's errors and calculation errors, many of them caused by communication errors during the drafting and review process.[28]

7. Some tax aspects of charitable giving don't have good answers; some don't have inexpensive answers; and some don't have any answers at all.

Donors generally want to do what they perceive to be "the right thing" for a charitable donee. However, Murphy's Law and the Law of Unintended Consequences sometimes get in the way. A donor can be so generous in her support of a smaller charity that it flunks the public support test, and risks becoming a private foundation.[29] A donor to a supporting organization can cause his son to lose his job.[30] If the deduction for certain property is limited to basis,[31] the cost of the qualified appraisal[32] may exceed the tax benefit of the deduction. A non-grantor trust is not entitled to a deduction for an otherwise valid conservation easement.[33] A donor of a truckload of oranges to a food bank did not know they needed a qualified appraisal. Some of these problems can be avoided if the donor asks advice before the donation, but often the first indication that there is a problem is when the donor meets with her accountant the following year, when it is too late to do anything.[34] The donor ends up without a tax benefit, and usually mad at the IRS, the charity, and their CPA (although Congress is generally to blame).

8. Charities and closely held businesses are not good bedfellows. Whatever else I think about the restrictions put in place by the 1969 Act, keeping private foundations from controlling closely held businesses is generally a good idea. When it does happen, typically either the charity or the business starves, since

[27] Prop. Reg. Secs. 1.1001-1 and 1.1014-5
[28] For examples: 9743004, 200601024, 9804036, 200233005, 200022014, 200447033
[29] Reg. Sec. 1.170A-9(e)
[30] Sec. 4958(c)(3)
[31] Sec. 170(e)(1)
[32] Sec. 170(f)(11)
[33] Goldsby v. Comr. TC Memo 2006-274 (TC 2006)
[34] Reg. Sec. 1.170A-13(f)(3)

they both need the same capital. Sharing the same cash flow is bad enough, but the business also will face tax restrictions on its normal operations.[35]

As many heirs have discovered to their distress, having a charity as a not-so-silent partner, demanding continuing cash flow, makes it difficult to run a normal business, even during the five years permitted under the excess business holdings rules.[36] Have some sympathy for the family whose business was left to the private foundation, but they inherited the building housing the business. Such an arrangement is impermissible, so they have to sell the business (building and all), forgo the rent their father intended them to live on, or buy out the business at fair value from the foundation during the administration of their father's estate.

9. Everyone thinks that their business/charity combination is the exception to Lesson #8. That assumes they even thought about it before bequeathing their business to their private foundation.

No matter what advice and experience the advisor offers regarding the difficulties of a business transferred to a charity, many business owners insist that this is the way it's going to be, so "you make it work." First-generation entrepreneurs who have built a business from scratch, but don't want to spoil their children (or pay estate tax), may firmly believe that this is the right answer for their family no matter what you say.

Whatever else advisors do, providing an exit strategy "just in case this arrangement doesn't work out" is the best favor they can do for their clients and their client's heirs. The regulations[37] provide a road map for a post-mortem sale to the family. By including appropriate purchase options in estate planning documents or other agreements, the planner can simplify the post-mortem transactions. A corporate redemption plan is another exit strategy that can be considered.[38] This gives the family the business opportunity for the future, while reducing the estate tax by passing the value to the charity. The number of rulings citing these regulations is a testimony to the good planning that can be done.[39] This area is now a no-rule area[40], but some guidance can be gleaned from the existing rulings.

10. Sometimes, doing the right thing isn't deductible. The best the advisor can do is quietly acknowledge the client's generosity.

If your neighbor dies, and you pay his daughter's tuition so she can finish private high school with her friends, that's a great thing to do—but it's not deductible. Neither is paying for a wheelchair ramp to be built so your gardener's mother can get out of her

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[35] IRC Sections 4941, 4942, 4944 and 4945
[36] Sec. 4943
[37] Reg. Sec. 53.4941(d)-1(b)(3)
[38] Sec. 4941(d)(2)(F)
[39] See PLRs 9350038, 200024052, and dozens of others citing 53.4941(d)-1(b)(3)
[40] Rev Proc 2014-4

house. And, as previously mentioned, auction donations of the use of property are not deductible either. Are those all charitable acts? Yes. But sometimes virtue must be its own reward.

11. No job is complete until the paperwork is done.

Since 1996, there has been a requirement that all donations of $250 or more be supported by qualified acknowledgment letters from charities, not just a cancelled check or credit card receipt.[41] Amazingly, this requirement is still occasionally overlooked.[42] Sometimes the receipt only says "thank you for your donation, which is deductible to the full extent of the law" instead of "thank you for your donation: you received no goods or services in return for your donation."[43] Sometimes, clients forget that they need to issue receipts from their private foundation or public charities that they founded.[44] Another area often missed is out-of-pocket expenses: although the charity does not have to issue receipts showing the amount expended, they should issue one describing the activity giving rise to the out- of-pocket expenses.[45] This is one area where an ounce of prevention is the only option: a late receipt is not valid.[46]

[41] Reg. Sec. 1.170A-13(f)
[42] Humphrey v. Comr. TC Memo 2013-198 (TC 2013) is a recent example.
[43] Sec. 170(f)(8)(B)(ii)
[44] Villareale v. Comr. TC Memo 2013-74 (TC 2013)
[45] Reg. Sec. 1.170A-13(f)(10) and Van Dusen v. Comr. 136 TC 515 (TC 2011)
[46] Reg. Sec. 1.170A-13(f)(3)