

# Professional Notes

SPRING 2016

TAX & ESTATE PLANNING

## Charitable Giving Update: Topics of Note in 2016

In this issue of Professional Notes, we discuss recent developments in the world of charitable gift planning. These include a gift-tax planning technique frequently used by donors who have hard-to-value assets and a desire to benefit charity as well as a tax provision enacted in 2008 that may make 2016 and 2017 a critical window for charitable gifts by hedge fund managers.

### IRA Charitable Rollovers Made Permanent

The individual retirement account (IRA) charitable rollover allows individuals age 70½ or older to transfer up to \$100,000 annually from an IRA to eligible charities on a tax-free basis. The distribution is excluded from income, yet counts toward the account owner's required minimum distribution. Because it is not included in income, there is no charitable deduction. The IRA owner may not receive any consideration for a rollover, and the funds must be transferred directly from the IRA trustee to the recipient charity. If these funds were drawn down by the IRA owner instead, they would be subject to income tax, which may not be fully offset by a charitable deduction. For the donor who has the means to part with some portion of his or her IRA assets and a philanthropic motivation, the rollover is a tax-efficient way to benefit charity.

Charities eligible for the rollover include public charities and private operating foundations. An unrestricted gift to The New York Community Trust, or a contribution to establish a field-of-interest fund (e.g., a fund for the environment or the advancement of education) or designated fund (a fund that

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Written by Brian Sweet of Patterson, Belknap, Webb & Tyler.

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supports one or more charities designated in the gift agreement) qualifies as an eligible recipient of an IRA charitable rollover. Donor-advised funds, however, currently are not eligible.

Originally enacted as part of the Pension Protection Act of 2006 and extended from time to time through December 31, 2014, the IRA charitable rollover provision was finally made permanent as part of legislation enacted on December 18, 2015. This change in the law was a relief to charities and donors, who for nearly a decade had been forced to wait until the waning days of December to see whether Congress would extend the rollover for another year. Individuals who wish to use IRA assets for charity may plan more proactively, perhaps years in advance, now that the rollover is permanent.

## **New Valuation Rule Established for Early Termination of NICRUTs and NIMCRUTs**

In our Spring 2015 edition, we considered the various ways charitable remainder trusts (CRTs) might be terminated early, including by a donation or sale of the income interest in the trust from the income beneficiary to the charitable remainder beneficiary. One key question is how the respective income and remainder interests should be valued upon an early termination, particularly in a net-income charitable remainder unitrust (NICRUT) or net-income charitable remainder trust with a “make-up” provision (NIMCRUT). Those net-income limitations are disregarded when valuing the respective income and remainder interests upon trust *creation*, but no clear valuation rule had been established for an early *termination*.

In the past, IRS private letter rulings took various positions regarding the valuation question, and its most recent pronouncement suggested that an income interest in a NICRUT or NIMCRUT should be valued using the lesser of (i) the applicable IRC Section 7520 interest rate at the time of the termination and (ii) the

unitrust percentage stated in the trust. (This is “one reasonable method” of valuing the interests, the IRS said, but it did not offer any clues as to what other reasonable methods might exist.) In a low-interest environment, the IRS-sanctioned method would result in a lower value for the income interest and a higher value for the remainder interest, effectively decreasing what the income beneficiary might expect to receive in sale proceeds upon a sale of his or her income interest to the charitable remainder beneficiary (as is deemed to occur in the typical early termination where each party receives its actuarial share). Some commentators disagreed with the IRS’s view, suggesting the unitrust percentage stated in the trust should be used to value the interests (thus tracking the way interests in a NICRUT or NIMCRUT are valued upon creation of the trust). Other commentators went further, suggesting that a market-rate “willing buyer-willing seller” method might be used to value the respective interests, using an appraisal that considers, among other things, the actual market performance of the CRT’s assets and its past income receipts.

Revised IRC Section 664(e) clarifies that, for any “early termination” of a NICRUT or NIMCRUT occurring after the December 18, 2015, date of enactment, the trust interests must be valued in the same way they are valued upon the creation of the trust, and net income limitations will therefore be disregarded. Neither the IRS nor the Joint Committee on Taxation has defined the full scope of what constitutes an “early termination” for purposes of this revised subsection, but it is arguably the case, notwithstanding the fact that Section 664(e) previously applied only for purposes of determining the amount of a donor’s charitable contribution, that the revised rule encompasses an actuarial split of the trust interests between the income beneficiary and the charitable remainder beneficiary—treated for income tax purposes as a sale of the income interest from the income beneficiary to the remainder beneficiary—in addition to an outright donation of that interest.

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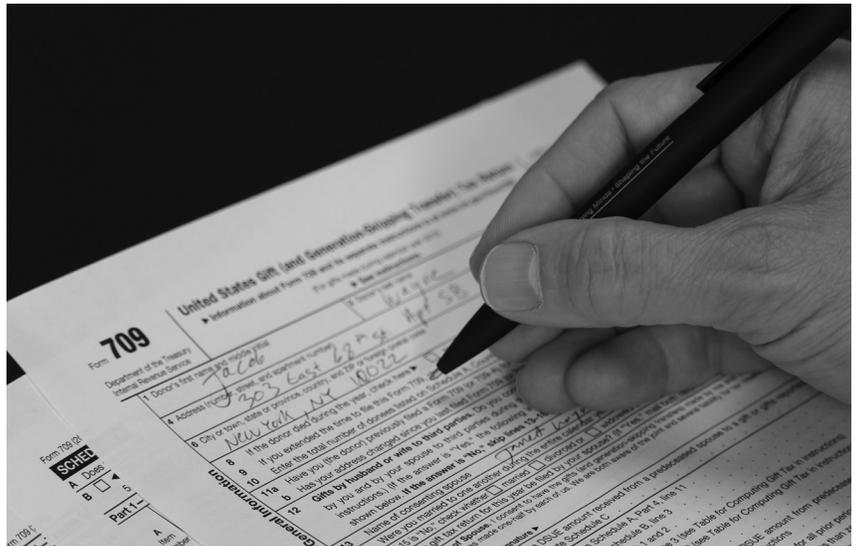
(The change in heading of the revised subsection is telling: It was previously titled “Valuation for Purposes of Charitable Contribution,” and is now titled simply “Valuation of Interests.”) This valuation rule appears to apply a ceiling on the value of the income beneficiary’s interest and a safe harbor for CRT beneficiaries who wish to engage in an early termination using this valuation rule, rather than the method the IRS had approved in its most recent rulings. However, the revised Section 664(e) should not preclude the charitable remainder beneficiary, in an appropriate case, from negotiating a lower value for the income interest, in which case the early termination may be treated for income tax purposes as a bargain sale from the income beneficiary to the charitable remainder beneficiary.

Beneficiaries of NICRUTs and NIMCRUTs may now proceed with greater certainty about this valuation issue upon an early termination of those trusts. In addition, although a long history of private letter rulings addressing early CRT terminations has given comfort to many taxpayers about the IRS’s general acceptance of such transactions, the revised IRC Section 664(e) raised early terminations of CRTs to a new level of acceptance, marking the first time they have been expressly recognized in the Code itself.

## Formula Gifts Involving Donor-Advised Funds

The year 2016 marks the fifth anniversary of the 9<sup>th</sup> Circuit’s affirmation of *Petter v. Commissioner* and the Tax Court opinion in *Hendrix v. Commissioner*, each of which recognized the binding effect of certain types of formula clauses used in gift and sale transactions. Donors have continued to follow the template these cases provide for engaging in gift and sale transactions in a manner that benefits family members and charity, while managing gift tax risks.

A key design feature of formula clauses like those used in these cases is their ability to reduce the risk of gift tax being imposed on gifts or sales to or for the



## Who are the permissible donees of a formula clause gift?

A charitable organization is not the only type of donee to whom transfers may be nontaxable for gift-tax purposes. Accordingly, planners have considered whether a spouse, a marital trust, or a grantor-retained annuity trust (GRAT) might be a permissible donee of the “excess” portion of a formula clause transaction. However, the opinions in both the *Petter* and *Hendrix* cases (as well as those in the *McCord* and *Christiansen* cases), in rejecting the IRS’s public policy arguments against formula clauses, cited reasons that are inherent only when a charitable donee is involved, such as the clear Congressional policy favoring gifts to charity. Accordingly, the validity of the formula clauses used in these cases may be in question if the beneficiary of the “excess” portion of the transaction is not a charitable donee.

The case of *Wandry v. Commissioner*, decided in 2012, upheld the use of a defined-value formula clause that did not involve a charitable entity. In that case, the “excess” value instead effectively remained with the donor. However, the IRS issued a notice indicating its nonacquiescence to that Tax Court memorandum opinion, and it remains to be seen whether the IRS will continue to challenge that type of formula clause. On the other hand, the approach of using a charitable donee to receive the “excess” portion of a formula gift has been accepted by all three Circuit Courts that have reviewed it, and the inclusion of a charitable donee seems to have set the preferred pattern among practitioners for formula gift and sale transactions.

Private foundations and certain charitable lead annuity trusts—because they are subject to private foundation rules regarding self-dealing, excess business holdings, and jeopardizing investments—are generally not recommended as potential recipients of the “excess” portion of a formula clause transaction. Indeed, both the *Petter* and *Hendrix* cases involved donor-advised funds at a community foundation.

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benefit of family members of assets that are difficult to value. If a donor desires to give or sell an interest in a closely held entity to a family trust (effectively transferring an interest to children or grandchildren), for example, that gift may be subject to gift tax to the extent its value exceeds the donor's remaining unified credit (and, if applicable, annual exclusion amounts). The value of the transferred interest claimed by the donor for gift-tax purposes customarily is supported by an independent appraisal. The IRS may, nonetheless, assert that the fair market value of the transferred interest has a higher value than the appraisal and seek to impose gift taxes, interest and possibly penalties on the donor. Use of a formula clause like the ones in *Petter* and *Hendrix* strengthens the donor's arguments against the imposition of taxes, interest and penalties, even if the IRS establishes that the transferred interest has a higher value than the appraised value.

Roughly speaking, the formula clause works as follows: The donor transfers certain interests in the asset (e.g. a 49 percent interest in a closely held entity) to a combination of family members and a charitable donee. The instrument transferring that 49 percent interest allocates the interest between those two classes of donees by the use of a formula that states the

portion of the interest having a defined dollar value (e.g. \$5 million "as finally determined for federal gift-tax purposes") will pass to the family donees (usually one or more long-term family trusts) and the balance to the charitable donee (commonly a donor-advised fund at a community foundation). Under a variation of this technique, the portion passing to the family donees is transferred in exchange for a promissory note from them. In either case, because what passes to the family donees is limited to a fixed dollar amount, even if a higher value for the 49 percent interest is successfully asserted by the IRS upon an audit of the transaction, their share is designed to remain valued at only \$5 million under the formula clause, and any "excess" value will accrue to the charity.

The IRS challenged these formula clauses based on a variety of theories, including that they are against public policy because they frustrate enforcement of the tax laws by discouraging audits. A successful challenge by the IRS on public policy grounds would be unlikely to result in any change to the economic substance of the transaction, which is defined by state property law, but might result in the disallowance of the donor's gift-tax charitable deduction for the "excess" amount passing to the charitable donee. The decisions in *Petter* and *Hendrix*, as well as prior decisions reached in the *McCord* and *Christiansen* cases, provided donors with comfort regarding these risks. In the five years since the *Petter* and *Hendrix* opinions were issued, the absence of any further public challenges to these types of formula clauses—and anecdotal evidence from planners—may indicate the IRS's willingness to accept their validity on similar facts.

## How much must pass to charity?

A key question underlying the *Petter* line of cases is how substantial the interest of the charitable donee must be for the transaction to be respected. The courts' analysis in these cases suggests that what is most important is that the charitable donee will receive value that is significant enough to merit the charity's proper review and diligence of the transaction. In *Petter*, the transaction was designed so the charitable donees would receive 10 percent of the transferred interests, based on appraised values; in *Hendrix*, the transaction was structured so the charitable donee would receive interests worth at least \$100,000. In ensuring that the charitable portion of a formula clause transaction is given substance, a donor who already has evidenced charitable intent through a pattern of giving also may be better off. The Tax Court in *Hendrix*, in particular, noted that the donors' creation of a donor-advised fund at a community foundation for purposes of the formula transaction did not "diverge from [the donors'] usual course of donation."

## Hedge Fund Managers Looking Ahead to High Income in 2017 May Wish to Consider Charitable Gifts Today

Prior to 2009, it was typical for U.S. hedge fund managers to employ fee-deferral arrangements within their offshore hedge funds. These arrangements provided a tax benefit to the hedge fund manager by deferring the income taxation of certain management

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and incentive fees accruing to the manager under the terms of the fund. Investors in these funds—typically foreign investors and U.S. tax-exempt entities—were indifferent as to when compensation was taxed to those managers. Congress targeted these arrangements in October 2008 with the passage of IRC Section 457A, which generally limited this type of fee deferral to a 12-month period.

The full contours of IRC Section 457A are beyond the scope of this summary, but what may be of particular note from the charitable planning standpoint is the provision of the 2008 legislation that effectively grandfathered pre-2009 fee-deferral arrangements, but only through December 31, 2017. As a result, many of these arrangements were amended to ensure that fees would be paid prior to the end of 2017, and the period between now and the end of 2017 may be one in which hedge fund managers face substantial tax bills on this deferred income.

Various strategies might be used by such managers in an effort to generate income tax

deductions to offset this deferred income as it is realized. The simplest approach might be a cash gift to a charity. A gift of highly appreciated long-term capital assets might provide an even greater benefit, in terms of avoiding the capital gains tax. A grantor charitable lead trust (see generally the October 2008 edition of *Professional Notes*) that pays an income or unitrust interest to a community foundation for a donor-advised fund is another option that may permit the donor to claim a substantial income tax charitable deduction while deferring decisions on the ultimate recipient of charitable funds.

## Conclusion

A number of gift- and income-tax planning opportunities are available to donors interested in providing for charity. Tax advisors will want to consider these recent developments when advising their clients in 2016 and beyond. In many cases, a community foundation such as The New York Community Trust can help. ■

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### **For further reference, see**

IRC Section 408(d)(8)

Protecting Americans from Tax Hikes Act of 2016, P.L. 114-113 (December 18, 2015), Section 112

IRC Section 664(e)

Protecting Americans from Tax Hikes Act of 2016, P.L. 114-113 (December 18, 2015), Section 344

PLRs 200208039, 200725044, 200733014, 200809044, 200816032-3, 201325018 (discussing valuation of interests in income-exception CRTs upon early termination)

Joint Committee on Taxation, Technical

Explanation of the Protecting Americans from Tax Hikes Act of 2015, JCX-144-15 (discussing § 344 of the Bill)

*Petter v. Commissioner*, 598 F.3d 1191 (9<sup>th</sup> Cir. 2011), aff'g T.C. Memo 2009-280

*Hendrix v. Commissioner*, T.C. Memo 2011-133

*Christiansen v. Commissioner*, 586 F.3d 1061 (8<sup>th</sup> Cir. 2009), aff'g 130 T.C. 1 (2008)

*Succession of McCord v. Commissioner*, 461 F.3d 614 (5<sup>th</sup> Cir. 2006), rev'g 120 T.C. 358 (2003)

*Wandry v. Commissioner*, T.C. Memo. 2012-88 (IRS nonacquiescence per IRB 2012-46)

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(212) 686-2563



909 Third Avenue, 22nd Floor  
New York, NY 10022  
(212) 686-0010  
nycommunitytrust.org



900 Walt Whitman Road, Suite 205  
Melville, NY 11747  
(631) 991-8800  
licf.org



210 North Central Avenue, Suite 310  
Hartsdale, NY 10530  
(914) 948-5166  
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