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The Blessings and Burdens of Drafting for and Administering Estates with Charitable Beneficiaries

Presentation to DC Bar Communities

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Overview of Drafting and Administration Issues

- Attorney General Notice Requirements
- Charitable Income Tax Deduction for Trusts and Estates
- Naming Charities as Beneficiaries of Retirement Accounts
- Considerations for Private Foundation as Estate or Trust Beneficiary
  - Self-dealing concerns and estate administration exception
  - Excess business holdings
  - 5% minimum distribution requirement

Attorney General Notice Requirements

- In every state, the Attorney General (AG) is charged with protecting the public's interest in charitable assets (*See, e.g.*, VA Code § 2.2-507.1(A))
- As a result, some states require you to notify the AG's office if assets are passing from an estate or revocable trust to charity
- The notice requirements and level of AG involvement vary significantly by state

ANY REQUIREMENT TO NOTIFY AG UPON DEATH OF DECEDENT?

	Will includes charitable bequest	***Revocable trust includes charitable bequest***
Virginia	No.	No. Although VA Code § 64.2-708(D) provides that the AG has the rights of a qualified beneficiary with respect to a charitable trust having its principal place of administration in the Commonwealth and even though § 64.2-701 defines charitable trust broadly as "a trust, or portion of a trust, created for a charitable purpose described in § 64.2-723", there is an exception in § 64.2-708(D) that says the Trustee need not provide the info and notices required under § 64.2-758 (Resignation of Trustee) and § 64.2-775 (Duty to Inform and Report) unless requested by the AG.
Maryland	No.	Yes. MD Est. and Trusts Code § 14.5-110 says "[t]he State's Attorney General has the rights of a qualified beneficiary with respect to a charitable trust having the principal place of administration of the charitable trust in this State" and § 14.5-103(e) defines charitable trust broadly as "a trust, or portion of a trust, created for a charitable purpose described in § 14-301(b) of this Article." As a result, the Trustee must notify the AG's office within 90 days of learning that a formerly revocable trust has become irrevocable pursuant to MD Est. and Trusts Code § 14.5-813.

ANY REQUIREMENT TO NOTIFY AG UPON DEATH OF DECEDENT?

	Will includes charitable bequest	***Revocable trust includes charitable bequest***
District of Columbia	No.	Yes. Same analysis as Maryland except that the Trustee must notify the AG's office within 60 days. *See* DC Code §§ 19-1301.10(c), 19-1301.03(3) and 19-1308.13.
Pennsylvania	Yes. Pa. O.C. Rule 10.5 provides that, within 3 months after the grant of letters of administration, the personal representative (or his or her counsel) must send written notice to the AG's office on behalf of any charitable beneficiary "(i) which is a residuary beneficiary, including as a beneficiary of a residuary testamentary trust; (ii) whose legacy exceeds $25,000; or (iii) whose interest in a legacy will not be paid in full".	Yes. PA Code § 7710(d) says "[t]he Office of Attorney General has the rights of a charitable organization expressly named in the trust instrument to receive distributions from a trust having its situs in this Commonwealth and the right to notice of any proceeding or nonjudicial settlement agreement in which there is a charitable interest or purpose." As a result, pursuant to § 7780.3, the Trustee must notify the AG's office within 30 days of learning that the settlor of the formerly revocable trust has died.

Charitable Income Tax Deduction for Trusts and Estates

- In general, there is no income tax deduction for bequests to charity at death
  - *E.g.*, "I leave the sum of fifty thousand dollars ($50,000) to the AMERICAN RED CROSS at my death."
- The charitable income tax deduction for trusts and estates is governed by IRC § 642(c)
- Among other things, IRC § 642(c) requires that, in order for a trust or estate to take a charitable income tax deduction, the charitable distribution must be paid from gross income
- A specific bequest is paid from principal, not income, so no charitable income tax deduction is generally allowed

More Tax-Efficient Options to Consider

- Encourage your clients to make charitable donations during life, rather than at death
- Leave the bequest to a trusted individual at death with non-binding language explaining that you hope and expect, but do not require, that he or she make a donation in that amount to the American Red Cross in your honor
- Allow pre-payment of charitable bequests in your estate planning documents
  - *E.g.*, "During such period of disability, my Trustees may prepay the charitable bequests listed in Paragraph 3, and such prepayments shall be deemed to be an advancement."

KEY DIFFERENCES BETWEEN IRC §§ 642(c) AND 170

- Two special qualification requirements under IRC § 642(c):
  - The charitable distribution must be made pursuant to the terms of the governing instrument and
  - The distribution must be made from gross income
- There are no percentage limitations under IRC § 642(c)
- IRC § 642(c) does not appear to be subject to the substantiation requirements of IRC § 642(c)
- The IRC § 642(c) deduction is more flexible in terms of timing:
  - Election to treat charitable distributions as having been made in the prior year (365-day rule)
  - Charitable set-aside deduction
    - Available to estates and pre-1969 trusts
    - Not available to revocable trusts unless the estate makes a Section 645 election
- Amounts paid to foreign charities qualify under IRC § 642(c)

IRC § 642(c) and Residuary Bequests to Charity

- If the residue of the estate passes to charity, we wouldn't expect the estate to pay income tax
- If state law directs income to charity as the residuary beneficiary, the governing instrument requirement is satisfied (*See* Casco Bank & Trust Company, 406 F. Supp. 247 (DC Me. 1975); *see also*, *e.g.*, PLR 8318043)
- Most, if not all, states have laws directing that, in the absence of a provision in the governing instrument to the contrary, income earned by an estate during the period of administration must be distributed to the residuary beneficiary (*See, e.g.*, UPIA § 202; VA Code § 64.2-1005(A); MD Est. & Trusts Code § 15-504(a)(1); DC Code § 28-4802.02(a))

IRC § 642(c) and Income in Respect of a Decedent

- "In general, the term 'income in respect of a decedent' refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent." Treas. Reg. § 1.691(a)-1(b).
- IRD is subject to both income tax and estate tax at death
- Examples:
  - Unpaid salary
  - Unpaid dividends, when death occurs on or after the record date
  - Remaining amounts due from an installment sale
  - Accrued but unpaid interest
  - Retirement plan benefits (*e.g.*, 401(k) and IRA proceeds)

IRC § 642(c) and IRD (Cont.)

- Wills and revocable trusts often include boilerplate language such as the following:

  "Except as otherwise provided in this governing instrument, I instruct my fiduciary that all of my charitable bequests (if any) shall be paid first with taxable income in respect of a decedent (if any), and second with any income generated by making the charitable bequest (if any), so that this estate shall be entitled to claim a charitable income tax deduction for such transfer under Section 642(c) of The Internal Revenue Code of 1986, as amended, or under any corresponding section of future income tax laws." Christopher R. Hoyt, *Make Your Charitable Estate Plan Great Again* Charitable Planning with Retirement Accounts: Strategies, Traps & Solutions (2018), available at https://hutchcf.org/wp/wp-content/uploads/2018/09/2018-Hoyt-Inc-Tx-Dedn-Charit-Bequest-IRD.pdf

- If the Will includes such language and the estate actually pays a charitable bequest from IRD, the estate should qualify for an IRC § 642(c) deduction

- Beware the economic effect rule in Reg. § 1.642(c)-3(b)(2)

EXAMPLE INVOLVING IRD*

*From Christopher R. Hoyt's article *Make Your Charitable Estate Plan Great Again,* Charitable Planning with Retirement Accounts: Strategies, Traps & Solutions (2018)

Facts:

- Client dies leaving a Will that says "I leave an amount equal to one hundred thousand dollars ($100,000) to the American Red Cross at my death and the rest of my Estate I leave to my daughter."
- The Will includes a provision directing the PR to pay all charitable bequests first from IRD.
- Assume the estate collected $20,000 from an IRA and the PR segregates the funds in a separate checking account.
- The only other income the estate received was $20,000 of qualified dividend income and $10,000 of tax-exempt income.
- The PR distributes the $20,000 of segregated IRA proceeds to the Red Cross and pays the remaining $80,000 to the Red Cross form the main checking account. The PR then distributes $30,000 to the client's daughter.

Analysis:

- The estate is entitled to a Section 642(c) deduction.
- HOWEVER, the deduction won't fully offset the IRD and won't fully shift the high-tax income away from the daughter.
- Instead, the charity's $20,000 and the daughter's $30,000 are each deemed to be 40% IRA income, 40% dividend income and 20% tax-exempt income.
- Because there is no deduction for tax-exempt interest, the estate can only claim a $16,000 charitable income tax deduction.

TAKEAWAY

- Include boilerplate language directing that charitable bequests be paid first from IRD
- BUT consider it a fallback position – don't rely on it
- It is generally better to name the charity as the beneficiary of the IRA via beneficiary designation form, rather than having the IRA paid to the estate and then having the estate make a distribution to the charity
- If there is a concern that the IRA will be too small at death, can instruct the Personal Representative to top off the amount passing to charity from the IRA
  - *E.g.*, "I direct my Personal Representative to pay to the AMERICAN RED CROSS the sum of fifty thousand dollars ($50,000), reduced (but not below zero) by any amounts distributable to the AMERICAN RED CROSS from qualified retirement accounts as a result of my death."

SECURE Act Changes for Account Beneficiaries

- Spousal beneficiary takes distributions over life expectancy
- New 10-Year Rule for distributions to most non-spousal beneficiaries
  - Tax payments and growth of traditional IRAS now compressed into 10 years
- Exceptions to 10-Year Rule for certain beneficiaries
  - Minor child (not grandchild) until age of majority
  - Disabled or chronically ill individual (or certain trusts for such person)
  - Beneficiary no more than 10 years younger (i.e., parents, siblings, cousins)
- New rules mean charitable gifts from accounts are even more desirable

Scenario for SECURE Act Issues

Thurston and Lovey

- The couple has no children
- Lovey has seven nephews in their 20s
- Both have several retirement plans
- They make large gifts to academic institutions and aviation charities

Qualified Charitable Distributions During Lifetime

- Make Qualified Charitable Distributions (QCD) to Thurston's alma mater
  - Direct transfer of funds from IRA, payable to qualified charity
  - Counts towards annual RMDs, as long as certain rules are met
  - Excluded from taxable income, unlike regular IRA withdrawals
  - Capped at $100,000 annually, per person
- Account owner must be 70 ½ years old to make QCDs

Roth Conversion and Donor Advised Fund

- Convert some of Lovey's traditional IRAs to Roth IRAs
  - Account owner should have separate funds to pay income taxes
  - To reduce income taxes, time conversion when account value is lower
- Contribute to Lovey's Donor Advised Fund (DAF) to offset tax liability
  - Make cash gifts
  - Donate appreciated stock

TESTAMENTARY CHARITABLE REMAINDER TRUST

- Fund a CRT with Lovey's retirement accounts for non-charitable and charitable beneficiaries
- More than one nephew may be named as a non-charitable beneficiary
- Non-charitable beneficiaries must be living at Lovey's death
- Charity is named in trust or someone is authorized to choose 501(c)(3)
- Individual receives distributions based on life expectancy or term of trust

Tax Implications of Charitable Remainder Trust

- Estate tax deduction for CRT is the value of charitable beneficial interest as presently ascertainable and severable from the non-charitable interest (Reg. § 20.2055-2(a))
- CRT does not owe income tax on account assets (IRC § 664(c)(1))
- Income earned within charitable remainder trust is not taxed
- Trust mimics "Stretch IRA" with assets growing tax-deferred beyond 10 years
- Nephew pays income tax on distributions to him
  - Tax is based on character as ordinary income, capital gains, other income, or principal (IRC § 664(b))

Testamentary Charitable Gifts Outright from IRAs

- Make outright gifts through beneficiary designations
  - Gifts to charity are tax-efficient with no income or estate tax due
  - Lifetime charitable pledges may be fulfilled
  - Shares may be set aside for both charitable and non-charitable beneficiaries
  - For 401(k), surviving spouse must consent if gift made to other beneficiary (IRC § 401(a)(11)(B))
- Consider disclaimer to implement charitable giving plan on first death

Provisions For Beneficiary Designations

- Draft custom beneficiary designations for complex distribution scheme
  - Shares set aside for both charitable and non-charitable beneficiaries, especially minors
  - Gifts that fulfill lifetime charitable pledges
  - Gifts to charitable remainder trust
- Ratably abate gifts when account balance insufficient at death
- Authorize party to carry out terms of beneficiary designation
- Hold IRA custodian harmless for compliance with beneficiary designation

Private Foundations and Self-Dealing

- IRC's "self-dealing" rules limit transactions between a private foundation and "disqualified persons"
- Violations result in taxes and penalties on self-dealers and foundation managers (IRC § 4941(a)(b)(c))
- When a private foundation is a beneficiary of a decedent's estate, certain direct and indirect transactions with the estate are considered to violate the rules
- Parties' intentions do not determine whether act is self-dealing

TRANSACTIONS PROHIBITED AS SELF-DEALING

- Prohibited transactions include (IRC § 4941(d)(1)(A)-(F)):
  - Sales, exchanges, and leasing of property
  - Loans or other extension of credit
  - Furnishing of goods, services, or facilities
  - Compensation or payment or reimbursement of expenses
  - Transfer of private foundation income or assets to, or use by or for benefit of a disqualified person
  - A private foundation's agreement to pay or give property to a government official (IRC § 4946(c))

Disqualified Persons with Respect to Self-Dealing

- Disqualified Persons include (IRC § 4946(a)(1)(A)-(G)):
  - Substantial contributor to foundation
  - Foundation manager
  - Owner of more than 20% of corporation, partnership, trust, unincorporated entity which is substantial contributor
  - Persons related to the above, such as parents, spouse, siblings, descendants
  - Corporations, trusts and estates in which disqualified persons own more than a 35% interest

Scenario for Self-Dealing Issues

Ginger and Gilligan

- Ginger owned 48% of outstanding shares of Closely Held Company
- Company manufactures high-end shoes
- Ginger executed promissory notes to buy shares
- Her Will bequeaths shares to private foundation as residuary beneficiary

Self-Dealing Issues with Estate

- Private foundation supports environmental causes in subtropical regions
- Company shares are not assets related to the active carrying out of foundation's exempt purposes (Reg. § 53.4941(d)-1(b)(3)(v)(b))
- Transactions between disqualified persons and Ginger's estate are prohibited as indirect self-dealing
  - Decedent's father was founder of foundation
  - Company is substantial contributor to foundation
  - Ginger's mother, sister, and brother are substantial contributors and foundation managers

Estate Administration Exception to Indirect Self-Dealing

- Exception applies to transactions during administration of a decedent's estate

  (Reg. § 53.4941(d)-1(b)(3))

- PR must have power to sell the property or reallocate it to another beneficiary, or be required to sell it because property was subject to an option when acquired

- Probate Court must approve transaction

- Transaction must occur before estate terminates for federal income tax purposes

  (Reg. § 1.641(b)-3(a))

Estate Administration Exception to Indirect Self-Dealing (Cont.)

- Estate must receive fair market value (FMV) of the foundation's interest or expectancy in such property at the time of the transaction
- Transaction
  - results in foundation receiving an interest or expectancy at least as liquid as one given up,
  - results in foundation receiving an asset related to active carrying out of its exempt purposes, OR
  - is required by an option that applied when the decedent acquired the property and is now binding on the estate

ADDRESSING SELF-DEALING ISSUES

- PR possesses a power of sale over assets of Ginger's estate
  - Sell at public or private sale, exchange for like or unlike property, convey, lease and otherwise dispose of any or all property, real or personal, held in my estate, for such price and upon such terms and credits as he or she may deem proper; to any person, specifically including a beneficiary, Personal Representative, Trustee of any trust created by me, or a descendant of my parents
- PR is authorized to satisfy debts of Ginger's estate
  - In determining assets available to my Personal Representatives for payment of such debts, expenses or taxes, . . . my Personal Representatives shall have discretion to determine whether my Residuary Estate shall be used in whole or in part to pay such expenses, debts or taxes

Addressing Self-Dealing Issues (Cont.)

- Petition probate court to allow Company to redeem shares and discharge notes
  - Estate would receive cash from Company in exchange for shares reduced by value of notes
  - Cash and debt relief would equal FMV of foundation's interest in Company at redemption
- Obtain valuation for closely held shares
- Determine interested persons and obtain consents and waivers for petition
  - Parties (PR, Company, foundation)
  - Other legatees whose bequests are not yet satisfied
  - Attorney General, depending on jurisdiction

Estate Planning for Self-Dealing Issues

- Educate clients about self-dealing rules and how rules affect dispositions
- Draft Wills, Revocable Trusts with powers to sell assets and satisfy debts
- Refrain from naming foundation as beneficiary of undesirable assets
  - Interests in closely held company
  - Promissory notes for private loans which will become receivables of estate
  - Real property not suitable for foundation's use

EXCESS BUSINESS HOLDINGS

- Under IRC § 4943, a private foundation generally cannot own any active trade or business in which its interests, together with the interests of disqualified persons, total more than 20%
- The excess business holdings rule also applies to donor advised funds and certain split-interest trusts (IRC §§ 4943(e)(1) and 4947(a)(2))
  - Charitable remainder trusts typically won't be subject to the excess business holdings rule due to an exception in IRC § 4947(b)(3)(B)
  - Charitable lead trusts will generally be subject to the excess business holdings rule if the charitable deduction allowed on the creation of the trust exceeded 60 percent of the value of the trust assets (IRC §§ 4947(a)(2) and 4947(b)(3)(A))

EXCESS BUSINESS HOLDINGS (CONT.)

- The ownership threshold increases from 20% to 35% if "it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation"
- Nonvoting stock is not considered excess business holdings if disqualified persons do not own more than 20% of the voting stock (IRC § 4943(c)(2)(A))
- 2% de minimis exception in IRC § 4943 (c)(2)(C)
- "Newman's Own" exception in IRC § 4943(g)

Definition of Business Enterprise

- IRC § 4943 only applies to "business enterprises"
- Business enterprise = "the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513" (Reg. § 53.4943-10(a)(1))
- The term "business enterprise" does not include:
  - A functionally related business
  - Program-related investments
  - A trade or business at least 95 percent of the gross income of which is derived from passive sources (IRC § 4943(d)(3))

Time Limit for Disposing of Inherited Excess Business Holdings

- 5-year grace period for interests a foundation receives by gift or bequest (IRC § 4943(c)(6)(A))
- Can get an additional 5-year extension in certain limited circumstances (IRC § 4943(c)(7))
- Important to flag excess business holdings issues early, particularly if the estate administration exception to indirect self-dealing would be helpful

Private Foundation Minimum Distribution Requirement

- In simplified terms, a private foundation must distribute an amount equal to 5% of its non-charitable assets each year (IRC § 4942)
- Inherited assets won't increase the foundation's distributable amount until they are actually received (*See* Treas. Reg. § 53.4942(a)-2(c)(2)(ii))
- Consider an intermediary CLAT to give the foundation time to ramp up operations (*See* Richard S. Franklin & Jennifer A. Birchfield Goode, *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, 39 ACTEC L.J. 355 (2013))

Meet the Speaker

Kasey Place focuses her practice on minimizing estate, gift and generation-skipping transfer taxes for high-net-worth individuals, both domestic and international. She has extensive experience with the formation of tax-exempt entities and regularly counsels private foundations and public charities with respect to governance and compliance matters.

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Meet the Speaker

Linda Kotis advises clients on forming and revising their estate plans and analyzes estate, income, generation-skipping transfer, and gift taxation matters for high-net-worth individuals and families. Her significant experience also includes charitable gift planning, retirement account planning, and estate and trust administration. She is a member of the District of Columbia, California, Indiana, and Maryland Bars.

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