Charitable giving: the rules of the road

Your guide to creating meaningful change

UBS Family Office Solutions / Advanced Planning Group / Family Advisory and Philanthropy Services

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Dear reader,

Since the inception of the United States, a hallmark of the American identity has been private philanthropy. The United States is one of the most philanthropic countries in the world.[1] This private philanthropy has funded many of the strongest charitable institutions in the world and has had a transformative effect on every aspect of American life.

Unlike many other developed countries, the United States has used its tax code to encourage charitable giving for more than 100 years by way of the income, gift and estate tax charitable deductions. During that time, the tax rules around charitable giving have evolved into a complex body of laws, restricting how and to which entities deductible charitable gifts can be made. Not following the rules can lead to the reduction or denial of the charitable deduction, along with possible tax penalties and interest.

As such, it is good to understand the basic rules of the road. That is the purpose of this piece. It provides a general overview of the tax rules around charitable giving, along with a description of the permissable vehicles available to accomplish the donor's philanthropic goals. Given the scope of the charitable planning field, this guide is meant to provide the big picture. If the reader is interested in delving deeper on a particular topic, your UBS Financial Advisor can provide additional whitepapers and information upon request.

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[1] Charities Aid Foundation, *World Giving Index 2022*.

Executive summary

Tax incentives for charitable giving

Since the introduction of the federal income, gift and estate tax charitable deductions over a hundred years ago, the tax code has provided significant incentives for charitable gifts and bequests. It is important to note that certain types of charitable transfers are given more favorable tax treatment than others. As we shall see, lifetime charitable gifts are more favorable than gifts at death, charitable gifts to public charities are preferable to gifts to private foundations, and gifts of appreciated property held long-term are typically better than gifts of cash.

Lifetime gifts vs. gifts at death

If you were to make a charitable bequest under your will of $1 million, that amount would qualify for the estate tax charitable deduction and would not be subject to estate tax. Not a bad result. If, on the other hand, you gave the $1 million in cash to charity during your lifetime, it would not be included in your taxable estate, but you would also get a $1 million income tax charitable deduction, in effect reducing current taxable income and income taxes. That would be a better result.

Public charity vs. private foundation

Charitable gifts to public charities (for example, churches, hospitals and schools) are treated more favorably by the tax code than gifts to private foundations (typically established by a single family or corporation). Lifetime gifts to public charities (other than gifts of tangible personal property that are not related to the recipient's exempt purposes) typically entitle the donor to a full fair market value deduction, while gifts to a private foundation (other than cash or publicly traded securities) are typically limited to the donor's basis. In addition, gifts of cash to a public charity are deductible at up to 60% of an individual's adjusted gross income (AGI) in the year of the gift, while cash gifts to a private foundation are only deductible at up to 30% of AGI.[1] Gifts of appreciated property held long-term to a public charity are deductible at up to 30% of AGI in the year of the gift but only at 20% of AGI for a private foundation. Unused charitable deductions are afforded a five-year carry forward.

Cash versus appreciated property

Many individuals use cash to make charitable gifts each year. While gifts of cash are quick and easy, they are often suboptimal from a tax perspective. Appreciated property held long-term is, typically, the most attractive form of property to give to charity during a donor's lifetime. Why is that the case? Let's look at an example. If you were to make a million-dollar gift of cash to charity, you would get a million-dollar income tax deduction. If, on the other hand, you gave a million dollars of low basis publicly traded stock that you had owned for more than a year, you would get a million-dollar deduction, but you would also avoid tax on the built-in capital gain. This effectively lowers the cost of the gift to the donor. When in doubt, always give low basis publicly traded stock held long-term to charity.

[1] More precisely, this and the other percentage limitations discussed in this guide are based on the donor's contribution base, which is the donor's AGI calculated without regard to any net operating loss carrybacks.

Charitable vehicles at a glance

Know your options

Private foundations

A private foundation is a form of charitable organization that usually receives its funding from an individual or a family. Although private foundations can operate programs, the principal activities of most private foundations are making grants to public charities and awarding scholarships to individuals. The major attraction of private foundations is that the donor and the donor's family can maintain control of the entity. Along with the benefits of donor control come certain burdens unique to private foundations. A private foundation is required to make grants of roughly 5% of its assets each year and is subject to an annual tax on investment income and excise taxes if it engages in a long list of activities prohibited by Internal Revenue Code Chapter 42.

Donor-advised funds

A donor-advised fund (DAF) is a giving vehicle where contributions are generally treated as gifts to a public charity for purposes of the deductibility limits. The donor receives an immediate income tax deduction for the amount contributed to the DAF, even though the assets may not be distributed to the ultimate charitable beneficiary for years to come. This allows individuals to make contributions in high-income years, build a charitable fund over time and then distribute the property to charities in the future.

Charitable remainder trusts

A charitable remainder trust (CRT) is an irrevocable trust that provides distributions to individuals during their lives (or for a term of not more than 20 years), with the remainder passing to charity at the end of the trust's term. Because a CRT is ordinarily a tax-exempt entity, it's attractive for the tax-efficient diversification of highly appreciated assets. Although the trust itself is generally not taxable, payments to the non-charitable beneficiaries are taxable under a system of taxation unique to CRTs known as the four-tier system. There are two basic types of CRTs, the unitrust (which provides for variable payments) and the annuity trust (which provides for fixed payments). Finally, the donor receives an income tax deduction in the year the trust is funded for the present value of the charitable remainder interest (which must be at least 10% of the amount contributed).

Charitable lead trusts

A charitable lead trust (CLT) is often described as a CRT "in reverse." It's an irrevocable trust that provides for distributions of an annuity or unitrust amount to a specified charity or charities for the life or lives of certain individuals, or for a term of years (with no 20-year limit), referred to as the ''lead term." At the expiration of the lead term, any property remaining in the trust passes to the donor's family or other non-charitable beneficiaries. Unlike a CRT, a CLT is not a tax-exempt trust. If the CLT is created during life, it will be taxed as either a grantor trust or a complex trust (non-grantor trust), depending upon how the trust is drafted. CLTs established at death are always taxed as complex trusts, with the trust receiving an income tax charitable deduction for the required annual payments to charity. The primary benefit of the trust is reducing or avoiding transfer taxes, and in the case of a grantor CLT, offering an income tax charitable deduction, with the potential to leave assets to non-charitable beneficiaries as a kicker. The donor (or the donor's estate) is entitled to a gift or estate tax charitable deduction for the present value of the payments to be made to charity during the lead term, valued (in part) using the 7520 rate. The 7520 rate is an interest rate published monthly by the Internal Revenue Service.[1] The donor must use the 7520 rate that's in effect for the month in which the donor (or the donor's estate) funds the CLT or, if the donor or the donor's executors so elect, either of the two months preceding the month of the transfer. If the assets in the CLT appreciate and/or produce income at a rate that exceeds the Section 7520 rate, the remaining trust property at the end of the lead term generally passes to the remainder beneficiary free from gift tax.

[1] More specifically, the 7520 rate is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii).

The Basics

For more than 100 years, there have been significant incentives for charitable gifts and bequests. It is important to understand the rules governing them, and that certain types of charitable transfers receive more favorable tax treatment than others.

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Income, gift and estate charitable deductions

There are three separate types of charitable deductions, with significant differences between them and different requirements. It pays to follow the rules.

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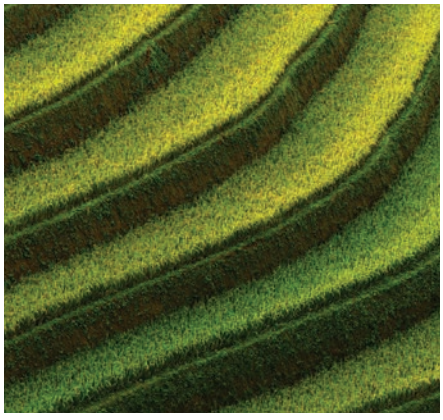
Charitable organizations

Gifts or bequests must be made to qualifying charitable organizations. Donations to public charities are treated more favorably than gifts to private foundations.



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Tangible personal property

Donations of appreciated personal property to charity such as art and collectibles can only be deducted for tax purposes at fair market value if they relate to the charity's purpose.

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Gifts of ordinary income property

The amount of any charitable deduction is reduced by the amount of any property that would not produce a long-term capital gain if it were sold.

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Public charities defined

The Internal Revenue Code defines three types of public charities. Organizations not meeting these definitions default to private foundation status.

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Charitable contributions defined

There is no clear definition in the tax code, but charitable contributions tend to have three characteristics in common.

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Reductions in the amount of the charitable gift

Gifts of certain types of assets to a private foundation are not deductible at fair market value for lifetime gifts.

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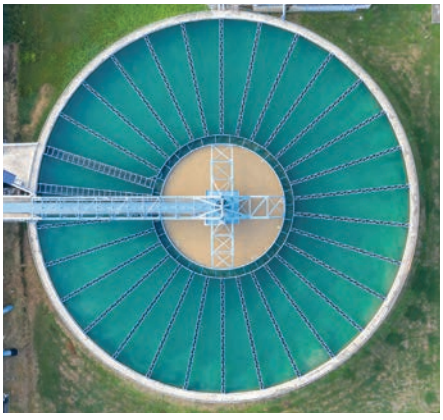
Charitable substantiation rules

Donors must substantiate their charitable gifts. The substantiation rules differ depending on the amount of the charitable gift and on the nature of the property contributed.



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Charitable gifts of complex assets

Gifts of complex assets such as closely held business interests, real estate or art bring tax traps for the unwary.

The basic rules

Income, gift and estate charitable deductions

While we speak generally of the charitable deduction, there are actually three separate charitable deductions set forth in different chapters of the Internal Revenue Code (IRC). They are as follows:

- IRC Section 170—Income tax charitable deduction
- IRC Section 2055—Estate tax charitable deduction
- IRC Section 2522—Gift tax charitable deduction

While the three deductions have much in common, there are significant differences, particularly between (i) the income tax charitable deduction, and (ii) the estate and gift tax charitable deductions.

In order to maximize the tax benefits of a lifetime charitable gift, the gift must satisfy the requirements of the income and gift tax charitable deduction rules. For most outright lifetime gifts to US charities, this is typically not a problem as such gifts qualify for both deductions.

An example of where there is a disconnect between the various charitable deductions is a lifetime charitable gift to a foreign charity that does not have a tax exemption under US tax law (or a US "friends of"-related charity). Such a gift does not qualify for an income tax charitable deduction but may qualify for a gift tax charitable deduction. Another example is the case of a deferred gift that is not in a form that is authorized by the tax code. For such a non-qualifying deferred gift, there is no income tax charitable deduction and no gift tax charitable deduction. This means that there is no current income tax charitable deduction to offset income on the donor's tax return, and that the donor will be deemed to have made a taxable gift, resulting in either the use of the donor's gift tax exemption, or, if the full exemption has already been used, an actual gift tax.

Unlike the income tax, the estate tax typically allows a charitable deduction for a transfer to a foreign charity. But the estate tax charitable deduction has its own tax traps. In order to qualify for the estate tax charitable deduction, the value of a charitable bequest must be "presently ascertainable" at the date of the donor's death. The seminal case on "ascertainability" is *Marine Estate v. Commissioner* (990 F.2d 136 (1993), aff'g 97 T.C. 368 (1991)), where under the decedent's will, the executors had discretion to make small bequests to certain non-charitable beneficiaries, with the residue of the estate payable to two public charities. The executors chose to make no non-charitable bequests. The court denied an estate tax charitable deduction because the executors had the discretion to make those non-charitable bequests, thus making the amount of the charitable bequest unascertainable as of the donor's death. Even though the executors made no non-charitable bequests and the estate passed to the two charitable beneficiaries, the estate was subject to a full estate tax with no offsetting charitable deduction. It pays to follow the rules.

Charitable organizations

In order to qualify for the income, gift and estate tax charitable deductions, the gift or bequest must be made to a qualifying charitable organization. The deductibility rules for the income tax charitable deduction distinguish between public charities and private foundations (while the estate and gift tax deductions typically do not). As with respect to the income tax charitable deduction, donations to public charities are treated far more favorably than gifts to private foundations.

Public charities defined

It is important to understand that the Internal Revenue Code treats a private foundation as a default status. If you can't satisfy the requirements for being a public charity, you are defaulted into private foundation status with its less favorable deductibility rules, as well as all the tax restrictions applicable to private foundations. The tax policy rationale for this is that public charities, unlike foundations, tend to generate a significant amount of their financial support from the general public and are, therefore, subject to significant public scrutiny to ensure that they are meeting appropriate standards of conduct. By contrast, private foundation support is typically limited to one family or corporation, and as such there is vastly reduced public scrutiny, which requires significant tax rules on foundation behavior that are overseen by the Internal Revenue Service (IRS).

IRC Section 509(a) defines a public charity. There are three types:

1. Inherently public charities—IRC Section 509(a)(1) describes organizations that are inherently public charities. These include churches, hospitals, schools and government entities.

2. Publicly supported organizations —IRC Section 509(a)(2) describes a publicly supported organization as an organization that is not inherently charitable but that receives substantial financial support from the general public. Examples include the American National Red Cross and United Way Worldwide.

3. Supporting organizations—IRC Section 509(a)(3) describes an organization that is operated exclusively for the benefit of one or more of the organizations described in IRC Sections 509(a)(1) and 509(a)(2).

Charitable contributions defined

It's difficult to find a good definition of what constitutes a qualifying charitable contribution in the tax code, but it basically boils down to three elements. A charitable contribution needs to be made in the following ways: (i) to a qualifying charitable organization; (ii) where the donor does not expect a substantial benefit in return; and (iii) where the payment exceeds the fair market value of any goods or services received in return. In addition, in order for a gift to be deductible, the gift must be complete. The retention of too much control by the donor after the gift, or the existence of future conditions that might defeat the gift, can postpone or prevent deductibility.

Quid pro quo

If the donor receives goods or services in exchange for the contribution (quid pro quo), the amount of the contribution must be reduced by the value of the benefit received by the donor. If the benefits received by the donor are too substantial, there may be no charitable deductions. Regarding quid pro quo, the donor generally may rely in good faith on the written statement of the recipient charity in exchange for the payment. It should be noted that not all benefits received from the charity by the donor reduce the amount of the deduction. The value of certain small items is not considered quid pro quo. For instance, items such as donor recognition and naming rights are disregarded.

Donor limitations and carry forward

In order for a lifetime contribution to be deductible, the donor must itemize deductions on the donor's tax return. In addition, a donor may not be able to take the full deduction in a tax year because charitable contributions are limited to a percentage of adjusted gross income during the year. The amount of the percentage limitations depends on two factors: (1) whether the gift is made to a public charity versus a private foundation; and (2) whether the gift is made in cash versus appreciated property held long-term. The AGI limitations are as follows:

Public charities

Cash gifts

1. 60% of AGI if cash is contributed outright (and there are no non-cash contributions) to certain public charities and donor-advised funds.
2. 50% of AGI if cash is contributed to a public charity, including donor-advised funds, in conjunction with donated appreciated property in a particular year.

Appreciated property gifts

1. 30% of AGI for gifts of appreciated property held long-term made in a particular year.

Private foundations

1. 30% of AGI for gifts of cash made in a particular year.
2. 20% of AGI for gifts of appreciated property held long-term made in a particular year.

5-year carry forward

If a donor cannot deduct the full amount of a gift to a public charity or private foundation in the year of the gift because of the AGI limitations, there is a 5-year carry forward for any unused deduction (subject to certain AGI percentage limitations).

Reductions in the amount of the charitable gift

Gifts of assets to a private foundation are not deductible at fair market value for lifetime gifts—with the exception of cash or qualified appreciated stock (public securities). Instead, the donor's deduction amount is valued at the lesser of fair market value or the donor's basis. This rule makes gifts of illiquid assets that have appreciated in value (like real estate or closely held business interests) unattractive for lifetime gifts to private foundations.

Tangible personal property

When a donor contributes appreciated personal property to charity (such as art and collectibles), there is only a fair market value deduction if the contribution is related to the recipient charity's exempt purpose. Otherwise, tangible personal property is deductible at the lesser of the fair market value or the donor's basis. For example, if a painting is contributed to a museum and that museum intends to add the painting to its collection (versus accepting the donated painting with the intent to sell it), it is generally deductible at fair market value because the exempt purpose of a museum is to exhibit art. If, on the other hand, the painting is contributed to the American Red Cross, the donor's deduction is limited to the donor's basis since exhibiting art is not one of the American Red Cross's exempt purposes. Alternatively, if the piece of art was donated by the artist, despite what the piece would have sold for on the market, the artist would only be able to deduct the cost of supplies.

Gifts of ordinary income property

The amount of any charitable deduction is reduced by the amount of any property that would not produce a long-term capital gain if the property were sold. So if the property is something like inventory, crops or dealer property, where the donor would receive ordinary income tax treatment for any income above the cost, and the donor contributes such property to charity, the donor's deduction would be limited to the basis in the asset.

Charitable substantiation rules

The IRS requires that donors substantiate their charitable gifts. If the donor does not have proper substantiation, the charitable deduction is denied. The substantiation rules differ depending on the amount of the charitable gift and on the nature of the property contributed. For charitable gifts of less than $250, the donor needs either a receipt from the donee charity, a bank record, or, for gifts of property other than cash, other reliable records. For gifts of $250 or more, the donor must have a written receipt from the charity that is contemporaneous with the gift. The receipt must also include information regarding whether any goods or services were received in connection with the gift, along with an estimate of the amounts that are not deductible. The charity can ignore the value of token gifts to the donor in connection with a donor's gift.

A gift of non-cash property between $250 and $5,000 requires a receipt from the charity and requires the donor to file a Form 8283 listing information about the property, such as acquisition dates, price and condition. A gift of non-cash property of more than $5,000 requires the donor to obtain a qualified independent appraisal.

Charitable gifts of complex assets

As we have seen in this guide, the tax rules around charitable giving can be complex. Nowhere are they as complex as when a donor is contributing complex assets (such as closely-held business interests, real estate or art and collectibles). These types of gifts have many tax traps for the unwary. While a full description of these tax traps is beyond the scope of this piece, we have published several whitepapers that discuss charitable gifts of specific complex assets.

Additional reading:

Planning for the Sale of a Closely Held Business, UBS Advanced Planning Group.

Estate and Charitable Planning for Art Collectors, UBS Advanced Planning Group.

Gifting to Charity Before or After the Sale of a Business, UBS Advanced Planning Group.

Charitable Planning with Closely-Held Business Interest, UBS Advanced Planning Group.

Charitable Gifts of Real Estate, UBS Advanced Planning Group.

Focus

What is venture philanthropy?

Venture philanthropy refers to an actively engaged process through which funders support organizations in maximizing their social impact over a long-term horizon. It applies the principles of business and, in particular, venture capital, to philanthropy in order to increase the efficiency and impact of those philanthropic efforts.

Early history

Although it has been hailed as a more recent concept, Andrew Carnegie and the first John D. Rockefeller were practicing aspects of venture philanthropy over a century ago. And the term "venture philanthropy" was actually coined by John D. Rockefeller III in the 1960s, when he described it as "an adventurous approach to funding unpopular social causes."

Carnegie and Rockefeller made their vast wealth as entrepreneurs during the Industrial Revolution that spread across America in the 19th century. They both established the first major foundations in the early 1900s and, through the application of both their entrepreneurial skill and belief in science, became the first venture philanthropists. They took on illiteracy and poverty among other social issues and also supported medical research, finding extraordinary success in these endeavors. Theirs was, as Rockefeller described it, the "business of benevolence." They applied the same passion and intensity to their philanthropy that brought them such success in business. Carnegie even wrote down his views on philanthropy and wealth in his book, *The Gospel of Wealth*, which has become the key text for modern venture philanthropists like Bill Gates and Eli Broad, among others.

More recent history and refinement

Throughout the 20th century, most philanthropy was not as engaged or strategic as that of Carnegie and Rockefeller. For the most part, philanthropy involved choosing a nonprofit and determining how much to give to it. Individuals wrote checks and foundations made grants. Once the check was cut, there was little ongoing involvement by the donor. Individuals and foundations were satisfied relying on the expertise of the recipient charity in utilizing the gift. Without ongoing involvement and proper tools for measurement, it was difficult to determine the impact of any particular gift.

The decade between 1999 and 2009 brought dozens of articles and books fleshing out the concepts of venture philanthropy, culminating in a seminal article by Mark R. Kramer, "Catalytic Philanthropy,"[1] published in the Fall 2009 issue of the *Stanford Social Innovation Review*. Catalytic philanthropy combines the effectiveness concepts of venture philanthropy with Carnegie and Rockefeller's emphasis on solving the world's great social problems.

Kramer states that catalytic philanthropists are effective because they engage in four distinct practices:

1. They have the ambition to change the world and the courage to accept responsibility for achieving the results they seek;
2. They engage others in a compelling campaign, empowering stakeholders and creating the conditions for collaboration and innovation;
3. They use all of the tools that are available to create change, including unconventional ones from outside the nonprofit sector; and
4. They create actionable knowledge to improve their own effectiveness and to influence the behavior of others.

[1] Mark R. Kramer, "Catalytic Philanthropy," *Stanford Social Innovation Review,* Fall 2009.

The theory

There is no definitive definition of the term "venture philanthropy." In fact, many experts think that venture philanthropy is a separate and distinct subset of "strategic philanthropy," like social entrepreneurship and catalytic philanthropy. This, however, seems to be more of an issue of semantics than substance. All of these concepts share an emphasis on impact, strategy and the application of performance measurement and application of management tools to philanthropy.

Traditional philanthropy often emphasizes narrowly focused and short-term grants, while venture philanthropists have developed a comprehensive approach that involves close monitoring, clear performance objectives and building a sustainable organization. In an article published in 1999 called "Philanthropy's New Agenda: Creating Value,"[2] written by Michael E. Porter and Mark R. Kramer (both national experts on business strategy), the authors offer four ways foundations could create social benefits beyond the immediate effects of grants by adopting the venture capital model. Like business investors, they could:

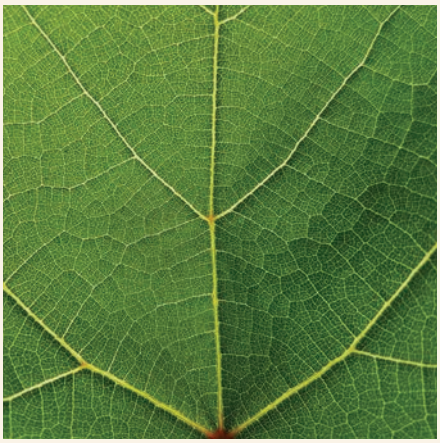
1. Use their expertise to select the best recipients of their funds and then measure the effectiveness of these selections;

2. Attract additional funding to these grantees by offering matching grants;

3. Actively partner with recipients to measure their performance; and

4. Conduct systematic studies of the long-term success of different types of projects and research new ways of addressing social problems.

[2] Michael E. Porter and Mark R. Kramer, "Philanthropy's New Agenda: Creating Value," *Harvard Business Review,* November – December 1999.



Core principles of venture philanthropy today

While there isn't just one approach to implementing a venture philanthropy strategy, there are several key criteria that are often present concurrently. The overarching theme is one of a purpose-driven and solutions-oriented philosophy. Below is a list of characteristics of venture philanthropy:

- Seeks to address a pressing societal or environmental issue
- Emphasis is on interventions that can be scaled, with the goal of systems change (supporting collective efforts to drive impact, as opposed to supporting one organization or project at a time)
- Structures funding mechanisms that can include targeted grants and/or investments
- Provides extensive non-financial support, including capacity building and advisory services
- Encourages innovation and risk-taking in finding solutions to the societal challenges being addressed
- Funders/investors are actively involved and committed to a years-long engagement, as they seek lasting impact in effecting systems change
- The focus is on the beneficiaries, or those populations that are directly benefitting from the offerings of the service provider. This can include those living in extreme poverty, refugees, children, women, those negatively impacted by climate change, or any other vulnerable population impacted by the societal or environmental issue being addressed.
- Monitoring and evaluation are key components of measuring outcomes and impact

At its core, venture philanthropy is a collaborative, cross-sectoral endeavor, often involving public-private partnerships. And the social purpose organizations implementing/driving change can be nonprofit entities, non-governmental organizations (NGOs), social enterprises or they may involve for-profits in some instances. The common factor here is that they have a proposed solution to a pressing societal or environmental issue.

The focus on outcomes while driving toward that solution is always the guiding "North Star," which encourages an iterative process to continually refine and improve program delivery. This methodology also emphasizes moving away from funding interventions that don't have measurable impact.

What is the future of venture philanthropy?

Historically, venture philanthropy was the domain of wealthy individuals, large private foundations and community foundations. While the dominant players are still the large institutions with the staffing and expertise necessary to engage in venture philanthropy on a large scale, venture philanthropy has become much more accessible to a wider range of individuals and small family foundations in the past decade. This is in large part due to improved information networks, online marketplaces and charity rating websites, along with community foundations and commercial donor-advised funds creating relevant offerings.

It's not a coincidence that venture philanthropy is on the rise along with Millennials' increasing share of charitable giving. The "Millennial Impact Report" reported that in 2014, 84% of Millennials donated to charity.[3] Millennials will have control over an unprecedented amount of money going forward, they are looking to engage deeply with organizations and they want to maximize their philanthropic impact in as many ways as possible. They embrace many of the core principles of venture philanthropy listed earlier.

Venture philanthropy is growing rapidly—having evolved from a few articles written about it in the 1990s to a major movement. Furthermore, it should continue to have a transformative effect on philanthropy in the coming years as more donors and charities adopt its practices and seek greater impact and systems change in addressing some of the large social issues of our time.

Additional reading:
A Practical Guide to Venture Philanthropy, UBS Advanced Planning Group.

[3] The Case Foundation and Achieve, *Inspiring the Next Generation Workforce: The 2014 Millennial Impact Report* (2014).

Donor-involved philanthropy

Donors frequently wish to remain involved with their gifts, often actively seeking to make them as effective as possible. There is a range of ways to do so.

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A long history

From the great fortunes of the late 19th century through the Silicon Valley entrepreneurs emerging in the late 1990s, donors have wanted to remain involved with their philanthropic gifts.

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Restricted gifts

The law protects donor-restricted charitable gifts, so that recipient charities do not violate their terms.

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Private foundations (non-operating)

A donor can make contributions to a private foundation that qualify for income, gift and estate tax charitable deductions. But foundations are subject to detailed rules.

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Private operating foundations

A private operating foundation operates charitable programs rather than making grants to public charities. Different rules apply.

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Donor-advised funds

Donor-advised funds act similarly to private foundations but are simpler in terms of administration. However, the donor has less control.

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Supporting organizations

A supporting organization is a type of public charity that supports one or more other public charities.

A long history

In the late 19th century, the United States saw the creation of great fortunes tied to the rise of the country as an industrial powerhouse. Among the greatest were those of John D. Rockefeller and Andrew Carnegie. Both were passionate about their philanthropy and both established foundations prior to the enactment of the income, gift and estate taxes in the United States. They practiced a very active form of philanthropy, sometimes known as the "business of benevolence," whereby they applied what they had learned in business to solving the country's greatest social problems. After World War II, we saw the rise of large institutional charities in the United States, which took over the role of the early philanthropists in trying to cure society's problems. In connection with the rise of large institutional charities, donors and private foundations became more passive; typically, they were just writing checks or making grants to other charities that actually operated programs.

This began to change in the late 1990s with the rise of Silicon Valley entrepreneurs who wanted to be more active in their philanthropy and wanted to use the principles of venture capital to create a new form of philanthropy; this has now become a major movement in private philanthropy. (Please see the section on venture philanthropy for further information.)

This section will describe the several ways that donors can stay involved with their philanthropy after a charitable gift is made. These include restricted charitable gifts and pledges, private foundations, private operating foundations, donor-advised funds and supporting organizations.

Restricted gifts

For centuries, the law has protected donor-restricted charitable gifts, so that recipient charities do not violate the terms of these gifts. The protection of donor-restricted charitable gifts is done at the state level, typically by statute. The state attorney general is the protector of all donor-restricted gifts and in many states is the only one who has legal standing to enforce the donor's restrictions. Depending on state law, the donor (or the donor's family) is prohibited from enforcing the terms of the donor's gift and is reliant on the state attorney general, who depending on the state may not be active in enforcing the terms of donor-restricted charitable gifts. This is why it is so important to have a properly drafted restricted gift agreement or pledge, which allows the donor to enforce the terms of the gift. Sometimes these agreements provide for something known as "gift-over" provisions, which state that if the charity violates the terms of the restricted gift, the assets are automatically gifted to another charitable organization.

Private foundations (non-operating)

General rules: A private foundation is a charitable organization to which a donor can make contributions that qualify for income, gift and estate tax charitable deductions. Typically, a private foundation receives its funding from one or a few private sources (usually an individual or family). The principal activity of a private foundation tends to be making grants to public charities. A private foundation may, however, operate a direct charitable program such as a museum, in which case it may be better for the foundation to be established as a "private operating foundation" (discussed below).

There are no minimums under either state law or federal tax law. However, the costs of setting up a private foundation and the annual paperwork involved in reporting foundation activities to the government suggest that there are better alternatives for donor-involved charitable giving (e.g., donor-advised funds) if the initial contribution amount is less than $5,000,000 (unless additional gifts or annual funding are contemplated).

If a donor funds a grant-making private foundation with cash or qualified appreciated stock, the donor's income tax charitable deduction is based on the full value of the amount contributed. If, however, the foundation is funded with property other than cash or qualified appreciated stock, the donor's deduction is based on the lesser of the donor's basis in the property and its fair market value. "Qualified appreciated stock" includes appreciated marketable securities held long-term for which market quotations are readily available on an established securities market.

The amount a donor can claim on the donor's tax return as an income tax deduction for a cash gift to a foundation is limited to 30% of the donor's adjusted gross income for the year, and to 20% of the donor's adjusted gross income for gifts of long-term capital gain property. Excess deductions can be carried forward for five years. A donor may receive a more favorable income tax

deduction if the gift is made to a private operating foundation.

Structuring the foundation: A private foundation can be created as a not-for-profit corporation or as a charitable trust. Typically, structuring the foundation as a trust is easier than a corporation. Certain powers (termination, amendment) should be spelled out in the trust agreement, and the trustees should be given the power to incorporate the foundation if at some future time that becomes desirable.

The corporate form is normally chosen if a foundation will conduct actual charitable operations, which expose the foundation managers to a greater risk of liability. The trust form is often used when a foundation will carry out its tax-exempt purposes by making grants to other charitable organizations.

Many private foundations are named for the individual or family that contributed the funds to the foundation. There are no special restrictions on naming a foundation organized as a trust. If a private foundation is incorporated, its name must be distinct from the names of other entities incorporated or qualified to do business in the same state. For corporate foundations, state law usually requires that the name must include words such as "Corporation" or "Incorporated" or an abbreviation thereof. Each state also has its own rules prohibiting the use of certain words in a not-for-profit corporation's name.

There are few restrictions on who can be the trustees, directors or officers of a private foundation (the "foundation managers"). If a private foundation is created as a not-for-profit corporation, state law requires it to have a minimum number of directors. An individual can usually be both an officer and a director. If a private foundation is created as a charitable trust, the person establishing the foundation can be the sole trustee and control all functions of the foundation, including distributions. However, there may be advantages to naming several trustees.

Charitable purposes of the foundation: Generally, a private foundation can be established for any recognized charitable purpose. Federal law requires that a foundation be organized and operated exclusively for "religious, charitable, scientific, literary or educational purposes," including the prevention of cruelty to children or animals.

A donor is not required to name or limit the type of charities the foundation will benefit nor is a donor required to limit the foundation to a particular charitable purpose. A donor can preserve an organization's flexibility by adopting general charitable purposes in its organizational documents and then, if the donor so chooses, leaving nonbinding written guidance and recommendations for future foundation managers regarding the particular charities and purposes the donor would like them to consider when making distributions.
If a donor wants to limit the ability of future foundation managers to change the foundation's focus, the

donor can restrict its charitable purposes in its organizational documents and restrict the power of future foundation managers to amend those purposes. A donor can also impose legally binding use restrictions on the donor's gifts to the foundation.

Under state law, a charitable trust can usually be perpetual, as can a not-for-profit corporation. Given the difficulty in foreseeing the future, it generally makes sense to give the foundation managers the discretion to terminate a foundation for any appropriate reason. Any assets remaining when a foundation is terminated must be distributed or expended for the foundation's charitable purposes.

Minimum distribution requirements: Private foundations are required to distribute a percentage of their assets each year for charitable purposes. This is known as the "minimum distribution requirement." The amount required to be distributed each year is 5% of the average value of the foundation's investment assets during the prior year, net any acquisition indebtedness used to acquire investment assets.

The foundation is required to make qualifying distributions equal to, or in excess of, the foundation's distributable amount by the end of the year following the year for which the distributable amount is calculated. Basically, the foundation has two years in which to make the required minimum distribution—the year for which the minimum distribution amount is calculated and the year immediately following.

If a foundation's qualifying distributions are less than the minimum required distribution amount, the foundation will be subject to an excise tax on the difference between the amount that was distributed and the amount required to be distributed (the "undistributed amount"). The initial tax is equal to 30% on the undistributed amount, and if not corrected in a timely fashion, a second-tier tax equal to 100% of the undistributed amount is imposed.

Foundation reporting requirements: Each year a foundation must file an annual return, Form 990-PF, with the federal government. The form sets forth its assets and liabilities, its taxable income, and information regarding the donations received and the grants and expenditures made during the year. Federal law requires a foundation to file a copy of its annual return with the attorney general's office in the state in which it is organized, the state in which it has its principal office, and any other state to which it reports or with which it is registered. State charitable registration and filing requirements vary from state to state. If a foundation does not solicit contributions, it is not required to register as a charity in some states.

Corporate-form private foundations generally have some additional state

reporting and filing fee obligations to satisfy in order to maintain their corporate status in the states in which they are incorporated and authorized to do business. In order to have their corporate form recognized for liability purposes, they must also observe the corporate formalities required under state law, including holding directors' meetings and keeping written minutes of all meetings.

Private foundation excise tax rules: Because of the unfortunate fact that many wealthy families use their private foundations for personal gain, Congress enacted a web of excise taxes and penalties, known as the Chapter 42 Excise Tax Rules, to discourage this type of behavior. With private foundations, donors get to exert a greater degree of control than they would with any other type of charitable vehicle, but they are also subject to the strictest penalties for abusing that privilege. The two excise tax rules most relevant to charitable planning are the prohibition against self-dealing and the prohibition against excess business holdings. The other tax rules are the tax on the failure to make minimum distributions to charity, the tax on jeopardy investments, the tax on taxable expenditures and the tax on net investment income of a private foundation.

Private operating foundations

A private operating foundation is an entity that operates charitable programs, rather than making grants to public charities. A private operating foundation looks like a public charity but does not meet the requirements for public charity status. Private operating foundations are treated as public charities for purposes of the income tax charitable deduction but are still subject to the excise tax rules applicable to private foundations.

Private operating foundations are not required to meet the minimum distribution requirements imposed on private foundations but are subject to various tests to ensure that the entity's activities are responsive to the general public.

Donor-advised funds (DAFs)

A DAF acts much like a private foundation and is a much simpler philanthropic option in terms of administration when compared to a private foundation. However, when using a DAF, the donor loses an element of control. Typically speaking, a donor makes a gift to a sponsoring charitable organization (usually community foundations or commercial DAFs), which sets aside the gift in a separate account in the donor's name, from which the donor suggests grants—typically to other public charities in which the donor has an interest. The donor doesn't have legal control over grant-making decisions from the account—the sponsoring organization does, although legitimate grant recommendations are generally followed by the sponsoring charity. DAFs, at least with respect to the deductibility rules, are more attractive than private foundations. Because the organizations sponsoring DAFs are public charities, charitable contributions of closely held business interests held over the long term qualify for a full fair market value charitable deduction, subject to certain discounts for lack of marketability and/or minority interests. As a result of this tax advantage over private foundations, DAFs are increasingly willing to accept contributions of closely held business interests, although because of the tax traps discussed below, such gifts may not always be tax efficient, and the sponsoring charity would typically look for a way to liquidate the assets in the short term (which should not be a problem if the business is being sold). If a donor funds a DAF with cash, the donor may deduct the gift up to 60% of the donor's AGI for the year and 30% for gifts of long-term capital gain property (like closely held business interests). If both cash and appreciated property are donated to a public charity in the same year, then the total deduction is limited to 50% of AGI. Deductions in excess of AGI can be carried forward for five years. DAFs can typically be established with far fewer assets than a private foundation.

Supporting organizations

A supporting organization is a type of public charity governed by IRC Section 509(a)(3). Unlike other types of public charities, such as churches, schools and hospitals, or organizations that qualify as public charities because of the amount of support received from the general public, a supporting organization's public charity status is derivative. A supporting organization qualifies as a public charity because it supports one or more other public charities, known as the supported organization or organizations.

Type III-supporting organizations had been marketed some years ago as private foundations without the headaches. As discussed earlier, private foundations are subject to strict operational requirements as well as a web of excise taxes that can apply not only to the foundation itself but also to "disqualified persons" with respect to the private foundation, such as substantial contributors, foundation managers and certain family members. Congress implemented the private foundation rules to limit the control that disqualified persons can have over a charitable entity. Clever planners discovered that with a few tweaks, a Type III-supporting organization could operate like a private foundation without any of the limitations on control. With the enactment of the Pension Protection Act (PPA) on August 17, 2006, it looked like those days were over.

A little background first. Under IRC Section 509(a), a charitable organization is considered to be a private foundation unless it meets the requirements necessary to be a public charity. Public charities that meet the requirements of IRC Section 509(a)(3) are known as supporting organizations. In order to qualify as a supporting organization, an organization must satisfy several requirements including the "relationship test." The relationship test requires that the organization be operated, supervised or controlled by or in connection with one or more publicly supported public charities. The purpose of the relationship requirement is to ensure that a supporting organization has a sufficiently close tie to one or more publicly supported public charities such that the supporting organization will be accountable to a broader public constituency.

There are three types of supporting organizations. A supporting organization that is operated, supervised or controlled by one or more publicly supported public charities is currently known as a Type I-supporting organization. The relationship that a Type I-supporting organization has with its supported organization(s) is comparable to that of a parent-subsidiary relationship. A supporting organization supervised or controlled in connection with one or more publicly supported public charities is commonly known as a Type II-supporting organization. The relationship a Type II-supporting organization has with its supported organization(s) is comparable to a sibling relationship. A supporting organization that is operated in connection with one or more publicly supported public charities is commonly known as a Type III-supporting organization.

Prior to the enactment of the PPA, the Treas. Reg. Section 1.509(a)–4(i)(7) required an organization to meet a "responsiveness test" and an "integral part test" to satisfy the relationship requirement for a Type III-supporting organization. The regulations provided that an organization is considered to meet the responsiveness test if the organization is responsive to the needs or demands of its publicly supported organizations. In addition, the regulations provided that a supporting organization is required to establish that it maintains a significant involvement in the operations of one or more publicly supported organizations, and such publicly supported organizations in turn depend on the supporting organization for the type of support it provides. This is known as the "integral part test." The regulations set forth two alternative ways to meet the integral part test. The first method is typically referred to as the "but for test." The second method of meeting the integral part test is known as the "attentiveness test."

The "but for test" is satisfied if the activities engaged in by the supporting organization for, or on behalf of, the publicly supported organizations are activities to perform the functions of or to carry out the purposes of such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.

The "attentiveness test" requires a supporting organization to:

(1) make payments of substantially all of its income to, or for the use of, one or more publicly supported organizations,

(2) provide enough support to one or more publicly supported organizations to ensure the attentiveness of such organizations to the supporting organization, and

(3) pay a substantial amount of the total income of such supporting organization to those publicly supported organizations that meet the attentiveness requirement. Rev. Rul. 76-208 defines "substantially all of its income" as 85% of adjusted net income.

The PPA made significant changes to the Type III-supporting organization rules in order to make such vehicles less subject to abuse. The PPA enacted IRC Sections 509(d) and 4943(f)(s).

These provisions define the term Type III-supporting organization and distinguish between functionally integrated and non-functionally integrated Type III-supporting organizations. These two new categories appear to reflect the distinction drawn in the existing regulations between those organizations that meet the integral part test by meeting the "but for test" and those that meet the integral part test by meeting the "attentiveness test." The bottom line of the changes made in the PPA is that a Type III-supporting organization can no longer be structured to act like a private foundation without the headaches.

Focus

Understanding motivations

The reasons why people give differ by generation. Studies show that regardless of generation or level of wealth, having a planned approach increases satisfaction and confidence in philanthropy.

We often say that "philanthropy is biography." To know what is important to a person, have a look at what charities or causes they support. This can provide meaningful insight into what they have experienced in their own lives that inspires their giving.

More than 91% of US households with a net worth of $1 million or more are engaged in some form of charitable giving. In households with a net worth of $5 million, that number climbs to 95%.[1]

Giving often starts with the practice of "checkbook philanthropy"—of making cash donations to organizations. Donations in this category are often of a responsive nature—making a donation to a nonprofit's direct outreach for a campaign, donating to a friend's race efforts, attending a gala or other fundraising event. And included in this category also are the direct donations to those organizations you have had a personal experience or connection with: your alma mater, local food pantry, the after-school program you attended as a child or your children attended, your place of worship, a local animal shelter and your favorite museum, to name a few.

What the recipient charities have in common in this category is that they are all personally meaningful and in close proximity to you, or they are important to the people who matter to you, and you donate to show your support to them. There is nothing wrong with either of these motivations, but the results are often less than optimal—you could be donating appreciated securities or giving through a charitable vehicle instead of cash, you don't know what impact those donations are having and this approach to making charitable contributions is scattershot at best.

[1] 2016 US Trust® Study of High Net Worth Philanthropy.

Beyond checkbook philanthropy

Based on a *UBS Investor Watch* report called *Doing Well at Doing Good: Why there's more to giving than checkbook philanthropy,*[2] most millionaires consider giving to be very important and make significant donations, but they also give without a plan in place to do so. Simply responding to incoming requests leaves them feeling uncertain about their impact and results in lower satisfaction in terms of whether they feel they are benefitting their communities and broader society. In fact, the study found that only 20% rate their overall approach to charitable giving as highly effective.

The causes that philanthropists support, and the reasons why they give, also vary greatly by generation. While helping the less fortunate is the most important concern across generations, older investors such as the WWII generation and "Boomers" are more likely to support traditional institutions, e.g., religious organizations, alma maters and the arts. Millennials, on the other hand, tend

[2] *UBS Investor Watch* 4Q 2014, *Doing Well at Doing Good: Why there's more to giving than checkbook philanthropy.*

to rally behind causes focused on tangible outcomes, such as fighting diseases, breaking cycles such as those of illiteracy or poverty, and reducing harmful behaviors, such as bullying or climate change.

However, across generations and across the financial spectrum, adopting a planned approach to philanthropy increases confidence in giving strategies as well as satisfaction with approach and impact. This study indicates that satisfaction increases in some instances by more than 50% when a philanthropic plan is created and utilized.

Developing a philanthropic plan can help accelerate your philanthropy and expand beyond the first concentric circle of organizations and causes that you already know and are familiar to you. It also helps you start moving away from "checkbook philanthropy." As part of your plan, you may want to begin developing a philanthropic allocation or "bucketing strategy" that can help you decide what to fund and what not to fund. Predetermined amounts of money or percentages of your budget can be allotted to differing interests or specific causes. Another way to bucket is to separate out mission-driven from more "reactive" giving (feeling obligated to respond to unsolicited requests from personal connections) and setting limits on this segment. This allows you to dedicate more resources to those issues in which you strive to have the most impact, and to decline grant requests that are unrelated to your mission.

Please see our publication *Strategic Planning for Philanthropy* for more information.

A closer look: donor-advised funds and private foundations

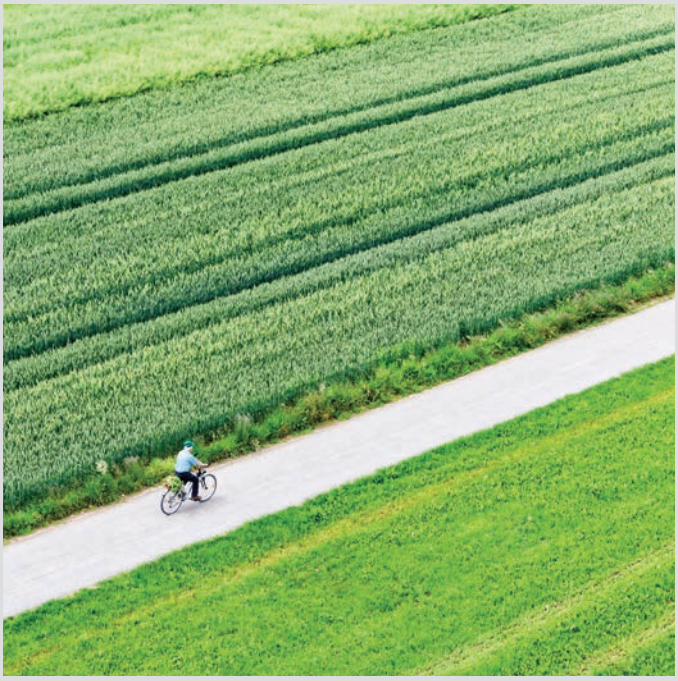
As you begin to think about how to formulate a plan or a strategy, the question around which charitable vehicles are best suited to help implement your vision inevitably comes up. We often field questions such as "Should I set up a DAF or a private foundation?" These are two of the most frequently utilized charitable vehicles, so it is not surprising that this inquiry comes up with such regularity. But this question cannot be answered responsibly without having more information, and without more reflection on the part of the philanthropist.

First, it is important to get a better sense of the "why" behind your philanthropy before we even get to the "what" or the "how." Here are some foundational questions for consideration:

- What do you care about? What is most important to you?
- Why are these issues important to you?
- Do you give out of passion, responsibility or obligation?
- Do you want to honor a loved one?
- Do you donate to bring your family together or teach values?
- Do you want to change the world in which we live?
- Do you want to address a specific issue or protect something beautiful?

The "why" will help you to clarify and articulate your philanthropic purpose, and the "what" and the "how" will inform your philanthropic plan and help you determine how you want to allocate your contributions. Here are some key considerations to help further clarify your approach, leading also to the selection of charitable vehicle(s) to help you achieve your philanthropic goals:

- How do you usually give? What assets are you giving and do you already have a charitable vehicle (e.g., donor-advised fund, private foundation or other)?
- Will you give all the assets during your lifetime?
- Do you plan to wind down over a certain number of years?
- Would you like your family or friends to continue to give once you're gone?
- Do you plan to add additional assets over time?
- Will you give away only the income of the investments or also the principal?
- How much capital do you need to apply to the problem you're trying to solve?



Determining the right charitable vehicle

Now if we return to the question of which charitable vehicle is best suited to help you achieve your philanthropic goals, the answer may actually consist of a combination of two or more options. Even if you already have a donor-advised fund (DAF) or a private foundation, that one vehicle may not be able to fully or sufficiently meet your needs, depending on what you are hoping to accomplish philanthropically.

Thus, in addition to the above considerations, there are some important features and distinctions to note that exist between DAFs and private foundations that can help drive toward the right configuration (if either/both of these vehicles are being considered). They each offer many benefits and in many instances can complement each other. For example, a DAF and a private foundation can work together to fund anonymous grants, facilitate donations of special assets and simplify international grant-making and operational administration.

Below are two sets of questions that will help you to determine whether a donor-advised fund or a private foundation (or both) provide the right solution to address your philanthropic goals.

First set of questions:

- Are you interested in having complete autonomy and freedom in your grant-making?
- Do you envision hiring and paying staff (possibly including family members) to execute your philanthropic vision?
- Do you feel comfortable having an annual distribution requirement?
- Are you willing to take on administrative responsibilities such as issuing grants, handling all the related paperwork and filing tax forms? Do you have the time and interest to take this on?
- Do you want to be able to engage in more sophisticated grant-making activities, including but not limited to program-related investments (PRIs) or making grants to individuals?
- Do you envision making multi-year commitments and being actively involved with your grant recipients? (See section on venture philanthropy for more information.)
- As part of your legacy plan, is it important for this philanthropic entity to exist in perpetuity, for future generations to also become involved?

If you answered "yes" to one or more of the above considerations, then a private foundation may be the right vehicle for your philanthropic goals.

Second set of questions:

- Is your grant-making largely going to focus on giving only to registered 501(c)(3) charities?
- Are you comfortable with making recommendations for grant recipients, as opposed to having total control over how and to whom the funds are granted?
- Are you not interested in taking on significant administrative oversight and responsibility for your philanthropy?
- Is anonymity in making charitable gifts an important consideration? (Be careful—private foundations, although called "private," include important information that is available to the public. Form 990-PF contains information on board members, on grants made to organizations and the associated dollar amounts, staff names and salaries, investment fees and total assets in the foundation.)
- Do you envision spending down all of the philanthropic assets in this vehicle in your lifetime, or possibly naming a successor advisor to help carry on your philanthropic wishes (but you are not interested in having this vehicle exist in perpetuity)?

If you answered "yes" to one or more of the above considerations, then a donor-advised fund (DAF) may be the right vehicle for your philanthropic goals.

The power of a plan

A philanthropic strategy should be reviewed on a regular basis—say, annually—and the philanthropic plan should be a living, breathing document. Engaged philanthropy is meant to be an iterative process, and revisiting both the strategy and the plan with regularity allows for shifts in your areas of interest as new issues arise or get on your radar, as well as allowing you to incorporate a growing knowledge about the causes you support. It also allows you to leverage technological innovations and new thinking from leaders in those sectors.

Another important component of your plan is the selection and activation of the appropriate charitable vehicle(s). Whether you are looking to solve an issue, address an unmet need or provide unrestricted support to a beloved local charity, the right vehicle(s) will help you to achieve greater impact, enhance your philanthropic vision and ultimately make you feel more fulfilled in your giving.

Please contact your UBS Financial Advisor to learn more about developing your philanthropic plan and exploring which charitable vehicle(s) are best suited to help you achieve your goals and aspirations.

Additional reading:

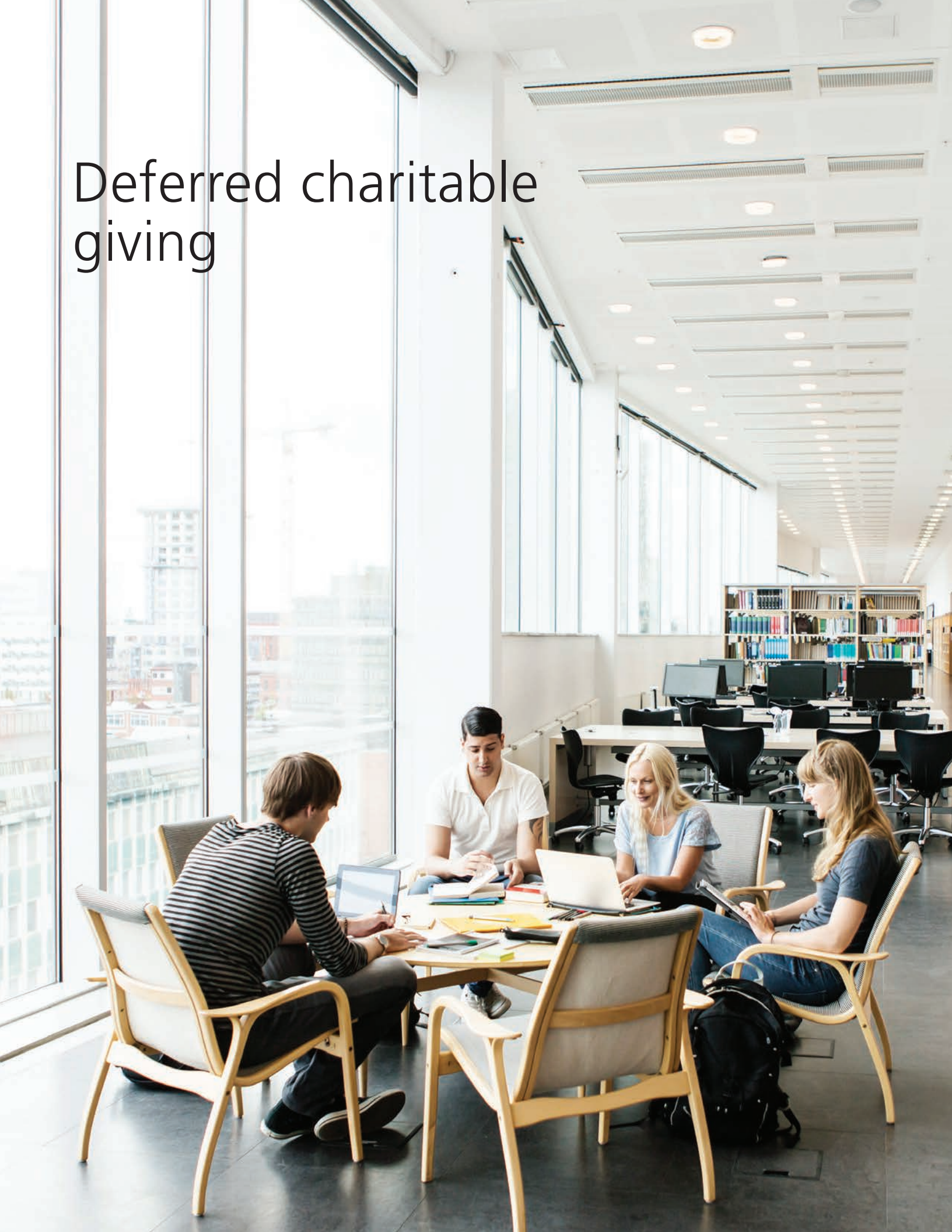
Strategic planning for philanthropy, UBS Family Advisory and Philanthropy Services.

Building a Strong Family Foundation, UBS Family Advisory and Philanthropy Services.

UBS Philanthropy Compass.

Doing Well at Doing Good: Why there's more to giving than checkbook philanthropy, UBS Investor Watch, Q4 2014.

Deferred charitable giving



Donors have a wide range of options for deferred charitable giving. It's important to know what they are.

page 46

Partial interest gifts

Generally speaking, gifts of partial interests in properties are not allowed. But there are exceptions.

page 46

Permissible partial interest gifts not in trust

Partial interest gifts are allowed if it is a fractional or undivided interest in the donor's entire interest in a property, if a gift is for conservation purposes or if it gives the charity a bargain.

page 48

Permissible partial interest gifts in trust

Partial interest gifts in trusts are permissible if the trust is either a qualifying charitable remainder trust or charitable lead trust.

page 51

Specific types of charitable remainder trust

There are two broad types of this tax-exempt trust—with either fixed or variable payments. Individual circumstances dictate which is most suitable.

page 53

Wealth replacement trust

As children do not receive anything at the end of a charitable remainder trust's term, many wealthy individuals set up a wealth replacement trust funded with life insurance.

page 53

Charitable lead trust

One or more charities receive the income stream of the trust for a set term, after which the non-charitable beneficiaries receive the remaining trust assets. The trust is not tax exempt.

Partial interest gifts

The general rule is that an income tax charitable deduction isn't allowed for a contribution of a partial interest in property; that is, a gift of less than the donor's entire interest in the property. Certain partial interest gifts, however, are deductible under the tax code. Deductible partial interest gifts fall into two basic categories:

(1) deductible partial interest gifts not in trust (including undivided interest gifts, contribution of a remainder interest in a personal residence or farm, qualified conservation easement and bargain sales), and

(2) deductible partial interest gifts in trust (charitable remainder trusts and charitable lead trusts).

Permissible partial interest gifts not in trust

Undivided interest gifts: An income tax charitable deduction is allowed for a transfer of a partial interest if that interest is an undivided portion of the donor's entire interest in the property. A deductible undivided interest consists of a fraction or percentage of each and every substantial interest, or right, the donor owns in the property that extends over the entire term of the donor's interest. An example of a permissible undivided interest gift would be where a donor owns a piece of investment real estate and gifts a 50% interest in all the donor's ownership interest in the property (including rent) to a public charity.

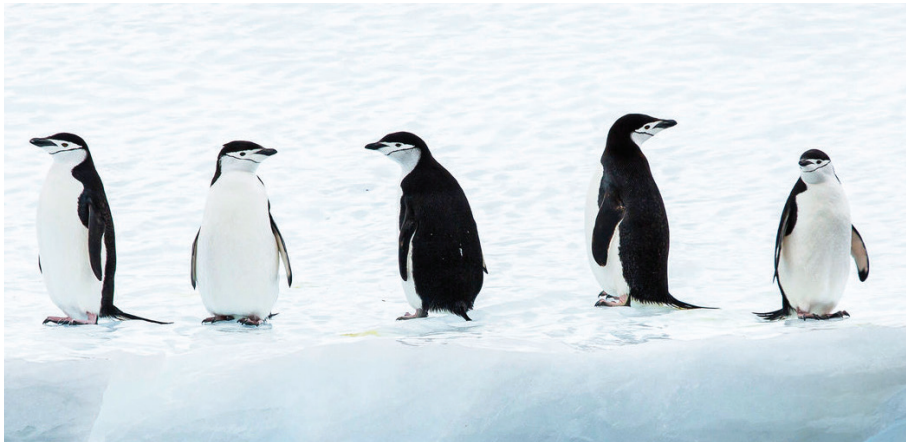
Contribution of a remainder interest in a personal residence or farm: A donor can get an income tax charitable deduction for the present value of a gift of a remainder interest in the donor's personal residence or farm, even though the donor or other individuals retain the right to life enjoyment. A "personal residence" is any property used by the donor as a personal residence, but it needn't be the donor's principal residence. For example, a donor's vacation home may be a personal residence. A "farm" is any land used by a donor (or a tenant) to produce crops, fruits or other agricultural products or for the sustenance of livestock. A gift of a remainder interest in a personal residence or farm must be outright (not in trust) to be deductible. Donating property subject to a mortgage isn't advisable because it results in the donor recognizing income to the extent of mortgage under the bargain sale rules.

Qualified conservation contributions: A contribution of a "qualified real property interest" donated to a "qualified organization" exclusively for "conservation purposes" is deductible. Conservation purposes include: preserving land for outdoor recreation; protecting a natural habitat of fish, wildlife or plants; preserving open space for the scenic enjoyment of the general public; and preserving a historically important land area or a certified historic

structure. Qualified real property interests include the donor's entire interest (while allowing the donor to keep a qualified mineral interest), remainder interests and conservation easements. Conservation easements are the most common type of qualified conservation contribution. An easement is a personal interest in, or the right to use, the land of another. By giving an easement, landowners limit their ability to use the land as they please. For instance, the owner may place restrictions on the type or size of buildings that may be erected on the property. To qualify, the easement must be perpetual and the recipient charitable donee must be a specifically described qualified organization (not all charities qualify) and must have the right to enforce the easement no matter who owns the land. For deduction purposes, the value of the conservation easement is based on a "before and after" analysis; comparing the property's fair market value based on the highest and best use of the property at the time of the gift (including development rights) with the value of the property subject to the easement. The reduction in the property's value is the fair market value of the easement, which is the amount of the charitable deduction.

Bargain sale: A bargain sale is a unique form of charitable transfer. It is part gift and part sale. For example, assume a charity wants to purchase a piece of real estate to use for its exempt purposes. The real estate is valued at $1 million, but the charity can only afford to pay $500,000. The donor could enter into a bargain sale with the charity where the donor sells the real estate to the charity for $500,000 and gifts the remaining $500,000 value of the property as a charitable donation for which the donor receives an income tax charitable deduction.

Another example of a bargain sale is a charitable gift annuity. A charitable gift annuity is a contract between the issuing charity and a donor whereby, in exchange for the contribution of a certain dollar amount (of cash or other property), the charity will pay the donor (or some other person) an annuity typically for the donor's lifetime. The annuity is not based on the full amount of the donor's transfer to the charity. Instead the transfer is a bargain sale, part purchase of an annuity and part charitable gift. The amount of gift/annuity depends on the age of the annuitant and, typically, is calculated using rates set by the American Council on Gift Annuities. The donor is allowed a charitable deduction for the gift component but not for the amount attributable to the purchase of the annuity.



Permissible partial interest gifts in trust

Charitable Remainder Trusts (CRTs)

CRT defined: A CRT is an irrevocable trust that provides for the payment of: (i) a specified distribution, at least annually; (ii) to one or more noncharitable beneficiaries; (iii) for the life of the beneficiary or a term of years not to exceed 20 years (or some combination of the two); (iv) with an irrevocable remainder interest to be paid to one or more qualified charities at the end of the trust term. CRTs can be established during life or at death.

The specific distribution to be paid annually to the non-charitable beneficiary or beneficiaries must be either (i) a set annual amount which is not less than 5% nor more than 50% of the initial fair market value of the property placed in the trust (in the case of a charitable remainder annuity trust), or (ii) a fixed percentage which is not less than 5% nor more than 50% of the fair market value of the trust assets valued annually (in the case of a charitable remainder unitrust [CRUT]). A qualified CRT is a tax-exempt entity and not subject to income taxes at the trust level unless the CRT has unrelated business taxable income in a particular year (which is taxed at 100% to the CRT). Although the trust itself is tax exempt, the annual payments to the non-charitable beneficiary, or beneficiaries, are taxable to the beneficiary under a system of taxation unique to CRTs, known as the four-tier system. When a donor sets up a CRT, the donor is entitled to an income tax charitable deduction. The deduction is not for the full amount contributed to the CRT, because the non-charitable beneficiary, typically the donor, retains the right to payments from the CRT. Instead, the deduction is for the present value of the charity's future remainder interest at the end of the trust term.

Income, gift and estate tax consequences

Income tax charitable deduction (IRC Section 170): In general, the donor to a CRT is entitled to an income tax charitable deduction in the year the trust is funded equal to the present value of the charitable remainder interest. The value of the CRT

remainder interest is determined (in part) using the 7520 rate. The 7520 rate is an interest rate published monthly by the Internal Revenue Service.[1] IRC Section 7520 provides tables for valuing the charitable remainder using an assumed rate of return for the non-charitable interest deemed to be earned during the trust term. The donor may elect to use the 7520 rate that's in effect for the month in which the donor funds the CRT or, if the donor so elects, either of the two months preceding the month of the transfer. Additional contributions to a CRUT are valued at the time of the addition when determining the income tax charitable deduction for the additional contribution.

Two additional important points should be noted when talking about the income tax charitable deduction for CRT. First, in order to have a qualified CRT, the income tax charitable deduction must be at least 10% of the fair market value of the property contributed to the CRT (the 10% minimum remainder test).

Second, the income tax charitable deduction is based on the basis of the contributed asset rather than the fair market value for certain types of property (ordinary income assets and tangible personal property), as well as for transfers of property that are not cash or qualified appreciated stock where a private foundation is permitted by the trust instrument to be named as a remainder organization.

Third, for certain types of property (ordinary income assets and tangible personal property), the income tax charitable deduction is based on the basis of the contributed asset rather than the fair market value. Further, if a private foundation is permitted by the trust instrument to be named as a remainder organization, then the income tax charitable deduction on transfers of property that are not cash or qualified appreciated stock will also be based on the basis of the asset. Qualified appreciated stock includes stock or mutual funds for which market quotations are available on an established securities market.

Charitable contribution percentage limitations:

a. CRT limited to public charity remainder—If the trust instrument provides that only public charities can be named as remainder organizations, the donor's income tax charitable deduction will be limited to 30% of AGI for gifts of long-term capital gain property, 60% of AGI for gifts of cash, and 50% of AGI for gifts of both cash and long-term capital gain property, with a 5-year carry forward for any unused deductions.

b. CRTs with ability to name private foundations as remainder organizations—If a CRT trust instrument allows a private foundation to be named as a charitable remainder organization, the donor's income tax charitable deduction will be limited to 20% of AGI for gifts of long-term capital gain property and 30% of AGI for gifts of cash, with a 5-year carry forward for any unused deductions.

[1] More specifically, the 7520 rate is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii).

Income taxation of the non-charitable beneficiaries: Although the CRT itself ordinarily is tax-exempt, the non-charitable beneficiaries' payments are taxed under a worst-in first-out system of taxation known as the four-tier system (which is unique to CRTs). Non-charitable beneficiary payments are taxed in the following order in a particular year:

1. Tier 1—Ordinary income to the extent of the CRT's ordinary income for the year and any undistributed ordinary income from prior years;

2. Tier 2—Capital gain to the extent of the CRT's capital gain for the year or any undistributed capital gain for prior years;

3. Tier 3—Tax-exempt income to the extent of the CRT's tax-exempt income for the year and any undistributed tax-exempt income for prior years; and

4. Tier 4—Tax-free return of principal.

Distributions in-kind: The unitrust or annuity amount may be paid in cash or in other property. If a distribution is made in property, the amount paid is considered an amount realized by the trust from the sale of the property. The basis in the hands of the recipient is its fair market value at the time it was paid.

Gift tax consequences: Transfers to a qualified CRT entitle the donor to receive a gift tax charitable deduction for the present value of the charity's remainder interest. The unlimited marital deduction is only available when one or both spouses are the only non-charitable income beneficiaries. Where there is an income beneficiary other than the grantor, there is a gift by the donor to the other non-charitable beneficiary (other than a US citizen spouse) equal to the actual value of the other non-charitable beneficiary's interest. It is possible for the donor (if the donor is the initial beneficiary) to avoid gift tax by reserving the right, exercisable only by the donor's will, to revoke only the other non-charitable beneficiary's successor interest in the CRT.

Estate tax consequences: As with the gift tax, a CRT only qualifies for the unlimited estate tax marital deduction if there is no non-charitable beneficiary other than the donor's spouse (except the donor). For example, a CRT which names the donor and the donor's spouse as non-charitable beneficiaries qualifies for the marital deduction, while a CRT which names the donor, spouse and children does not qualify and will be subject to estate tax at the donor's death. Finally, in order to have a qualified CRT, the trust instrument must include a provision that no estate taxes attributable to the CRT shall be paid out of the trust assets.

Reasons to establish a CRT:

1. Tax-efficient diversification for a low basis asset or group of assets.

2. Increased cash flow on a low or no dividend-paying asset.

3. Estate tax minimization using a wealth replacement trust (discussed below).

4. Supplementing retirement income.

5. Business succession planning.

6. Income tax charitable deduction.

7. Deferral of income taxes.

Specific types of CRTs

There are basically two categories of CRTs: those with fixed payments, charitable remainder annuity trusts (CRATs) and those with variable payments (CRUTs). While there is only one type of CRAT, there are four types of CRUTs (the standard CRUT, the net income only unitrust—no make-up [NICRUT], the net income with make-up unitrust [NIMCRUT] and the FLIPCRUT). These will be discussed below. It is important to note that no additional contributions (after the initial contribution) are permitted to CRATs, while additional contributions to CRUTs can be made at any time.

CRATs

CRATs are fairly straightforward. For example, a donor contributes $1 million to a 5% CRAT for the donor's lifetime. The donor will receive 5% of the initial contribution or $50,000 a year for the donor's lifetime, so long as the trust has the assets to make the payment. If the assets increase over the donor's lifetime, the donor does not benefit in terms of increased payments. If, on the other hand, the trust assets decline in value, the donor is not penalized (although the trust may be depleted more quickly). Again, no additional contributions can be made to a CRAT.

CRUTs

Standard CRUT—Unlike a CRAT where the payments are fixed, with a CRUT the payments vary from year to year based on the performance of the underlying trust assets. Using the example above, if a donor contributes $1 million of low basis public stock to a 5% CRUT, the donor is entitled to 5% of the trust assets annually as revalued on January 1 of each year. In the first year of the CRUT, the annual payment will be $50,000, which is the same as the CRAT. If by year 10 the trust assets have increased to $2 million, the donor is entitled to receive 5% of $2 million or $100,000 in that year.[4] What if instead the assets in year 10 had diminished to $500,000? Then then donor would receive 5% of $500,000 or $25,000. Because the unitrust payments can vary from year to year, with a CRUT the donor can make additional contributions to the trust at any time, and is entitled to both increased payments for the additional contributions as well as an additional income tax charitable deduction in the year of any additional contribution, equal to the present value of the remainder organization's interest, based on the IRC Section 7520 rate in effect at that time.

NICRUTs (rarely used)—With a NICRUT, each year the income beneficiary is entitled to receive the lesser of the stated percentage (say 5%) or the actual trust income. If the actual trust income for the year is less than the stated percentage, the income beneficiary only receives the actual trust income. Any difference between the stated percentage and the amount actually received is lost, even if the trust's income exceeds the stated percentage in a subsequent year. As such, the other CRUT strategies, mentioned below, tend to be preferred to NICRUTS.

NIMCRUT—With a NIMCRUT, the income beneficiary is entitled to receive the lesser of the stated percentage and the actual trust income. Where it differs from a

[4] For illustration purposes only. Does not reflect the impact of taxes or fees.

NICRUT is that the difference between the actual income distributed and the stated percentage is kept track of in a make-up account (basically an "I owe you"). If the trust income exceeds the stated percentage in future years, the income beneficiary is allowed to receive the distributions up to the amount of the make-up account. NIMCRUTs can be structured so that the make-up account can be deferred to a year when the income beneficiary would like to draw down on it (for example, retirement).

FLIPCRUT—The FLIPCRUT is the new kid on the block. It has only been permitted since 1998. Technically known as a "combination of methods" unitrust, the FLIPCRUT trust typically starts out as a NIMCRUT and then, upon the occurrence of a "triggering event," it flips and becomes a standard CRUT as of January 1 of the next calendar year. The triggering event may be: (i) a specific date; (ii) the sale of an illiquid asset held by the trust; or (iii) a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other person (IRS examples include marriage, death, divorce or birth of a child).

CRAT versus CRUT

A CRAT allows the charitable remainder organization to reap the benefit of all appreciation remaining in the trust after annuity payments (along with the risk of loss) while ensuring a fixed annual payment to the income beneficiary. A CRUT allows the income beneficiary to participate in any appreciation (or reduction in value), since the unitrust amount will either be increased or decreased each year depending on the performance of the trust investments. As such, a CRAT is typically only utilized for older donors (75 or older) who want a fixed annual payment and do not believe they will live long enough to see their purchasing power on distributions dramatically reduced by inflation. Remaining donors should consider the CRUT.

Which type of CRUT to choose?

1. Standard CRUT—Typically chosen by individuals who are 50 or older who want to: (a) diversify out of a low basis concentrated publicly traded security; (b) increase income; and/or (c) do some estate planning using a wealth replacement trust.

2. NIMCRUT—Since the introduction of the FLIPCRUT in 1998, NIMCRUTs are now primarily used by wealthy individuals for income deferral purposes such as supplemental retirement savings.

3. FLIPCRUT—Typically used when a CRT is funded with an illiquid asset, such as real estate, closely held stock or tangible personal property.

Wealth replacement trust

Because the remainder interest in a CRT passes to charity, the children do not receive anything at the end of the CRT term (typically upon the death of the survivor of their parents). As such, many wealthy individuals who set up a CRT also set up an irrevocable wealth replacement trust that is funded with second-to-die life insurance that is not included in their estates, to replace assets for the family that will ultimately pass to charity. A portion of the after-tax payment from the CRT each year is used to make a gift to the wealth replacement trust to pay the insurance premiums.

Charitable lead trust (CLT)

In general: A CLT is often referred to as a CRT in reverse, because the usual roles of the charitable and non-charitable beneficiaries are reversed. In a CLT, one or more charities receives the income stream of the trust for a certain time period, and at the end of the trust term the non-charitable beneficiaries receive any remaining trust assets. The "lead interest" in a CLT is the charity's right to receive payments from the trust for a certain term. That right may take the form of the right to receive an annuity payment or a unitrust payment. An annuity payment is the right to receive a fixed amount from the trust each year that does not change from year-to-year. A unitrust payment is the right to receive a specified percentage of the trust assets revalued each year. The vast majority of CLTs are annuity trusts. The "term" of a CLT is the length of time over which the charity is to receive its annuity or unitrust payments. The term may be the life or lives of a permitted individual or individuals, a term of years, or a combination of the two. In contrast to a CRT, the term of a CLT need not be limited to 20 years. The "remainder interest" is the right of the non-charitable remainder beneficiaries to receive the remaining principal of the trust at the expiration of the charitable term. The remainder beneficiaries are typically children, as a CLT is not an effective vehicle for generation-skipping planning.

Qualified CLTs

A qualified CLT is a CLT that meets the various Internal Revenue Code requirements for the deductibility of the lead interest for estate, gift and/or income tax purposes. A qualified CLT may be either set up during lifetime or at death. A lifetime CLT provides gift tax advantages and, in some cases, may also produce an income tax charitable deduction. A testamentary CLT only provides estate tax advantages.

Unlike a CRT, a CLT is not a tax-exempt trust. The way trust income is taxed depends on whether the CLT is a "grantor" CLT or a "non-grantor" CLT. With a grantor CLT, the donor (grantor) is treated as the owner for income tax purposes because of certain powers the grantor, or parties related to the grantor, retain over the trust. The benefit of a grantor CLT is that the donor gets an income tax charitable deduction at the time the trust is

funded—typically for the amount contributed. The burden of a grantor trust is that the grantor personally pays all the income taxes on trust assets during the trust term with no offsetting deduction for amounts paid to charity, because the income tax charitable deduction was taken up front. A non-grantor CLT is taxed as a standard "complex" trust for income tax purposes, meaning that the trust itself is taxed on all its undistributed income and on all capital gains. However, a non-grantor CLT receives a charitable income tax deduction for the annuity or unitrust payment made to charity each year. A grantor CLT does not receive such a deduction.

Charitable lead annuity trusts (CLATs)

Most CLTs, whether established during the donor's lifetime or at death, are set up so that there is no gift or estate tax value to the children's remainder interest. Like a CRT, a CLT values the lead and remainder interest valued (in part) using the 7520 rate. The 7520 rate is an interest rate published monthly by the Internal Revenue Service. The donor must use the 7520 rate that's in effect for the month in which the donor (or the donor's estate) funds the CLT or, if the donor or the donor's executors so elect, either of the two months preceding the month of the transfer. In October 2022, this rate was 4%. Using a computer program, you can determine what payment will be necessary so that there will be zero gift tax (for lifetime CLTs) or estate tax (for testamentary CLTs) for the children's remainder interest. You can only do this for a CLAT because the payments to charity are fixed. These types of CLTs are known as zeroed out CLATs, and they represent the vast majority of CLATs that are established. If, over the annuity term, the assets in the CLAT appreciate at a rate that exceeds the 7520 rate used to value the annuity interest, the appreciation in excess of the 7520 rate generally passes to the donor's children free from gift and estate tax. For example, if you set up a 15-year, zeroed-out CLAT funded with $10 million when the IRC Section 7520 rate is 4% and you are able to average a 7% return over the trust term, there could be approximately $5 million in assets available to the children free of transfer taxes at the end of the 15-year CLAT term.

Although we speak of CLAT annuity payments as fixed, the IRS permits the annuity payments to increase over the trust term. This is known as a back-loaded zeroed-out CLAT. The thought is that the longer the assets stay in the CLT and are not paid out to charity in the form of the lead payment, the more likely it is that the assets will outperform the IRC Section 7520 rate over the term. For example, the same 15-year, zeroed-out $10 million CLAT with annuity payments increasing by 20% annually could leave approximately $7 million for children at the end of the 15-year CLAT term. It is not clear how far the CLAT payments can be back-loaded, but a safe harbor seems to be that the annuity payments can increase 20% each year.

Permissible charitable lead beneficiaries

Both public charities and private foundations can be named as lead beneficiaries of a CLT. But, unlike CRTs, where the donor can retain the right to change charitable remainder beneficiaries at any time, a CLT does not permit the donor to retain the right to designate charitable lead beneficiaries after the trust is established. If the donor retains such a right, the donor is not considered to have made a completed gift and the trust assets will be included in the donor's taxable estate. In addition, if the lead beneficiary is a private foundation, the CLAT assets will be included in the donor's taxable estate if the donor has the right as an officer, director or trustee of the foundation to participate in grants made by the foundation with respect to assets that the CLAT pays to the foundation. Those funds should be kept in a separate account and the donor should have no right to participate in grants that are made from such account.

Testamentary CLATs

If a wealthy individual has a large bequest to a public charity or a private foundation at death, and also has children, the individual may wish to have the bequest pass instead to a testamentary CLAT. If the CLAT is structured to be zeroed out at the donor's death, the donor's estate will still receive a full estate tax charitable deduction, just like with a charitable bequest, but if the CLAT can outperform the IRC Section 7520 rate in effect at the donor's death, there should be significant assets that pass to the donor's children estate tax free at the end of the CLAT term.

Conclusion

Few firms have the global experience and breadth of resources necessary to help successful families take a strategic approach to managing their wealth for continuity. UBS has been a thought-partner to exceptional families around the world for generations, advising them on passing on their wealth to heirs and charitable organizations, as well as using their good fortune to create meaningful change in the world. Please contact your UBS Financial Advisor for more information.

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In January 2019, Nicole joined the newly formed Family Office Solutions (FOS) team within UBS Private Wealth Management, serving as a Senior Strategist representing Family Advisory and Philanthropy Services Americas. Nicole works closely with Advisors in Private Wealth Management, where FOS delivers dedicated and comprehensive services to ultra high net worth clients.

In this role, Nicole works with families on understanding values and philanthropic intent in the context of family wealth. She provides advice on family wealth education, communication and decision-making, multigenerational wealth transitions, and family governance as well as on charitable vehicles and building and enhancing philanthropic legacies. She also helps clients to be strategic and impactful with their philanthropic giving.

Nicole joined UBS in 2014 to establish and lead the UBS Optimus Foundation presence in the US, a global network that supports programs focused on the potential to be transformative, scalable and sustainable in the areas of health, education and child protection. Under her leadership, the Foundation platform became available to all clients and employees of UBS Financial Services Inc., and this offering now serves as a true differentiator and is a core component in delivering the firm.

Nicole has over two decades of experience in the nonprofit, philanthropic and corporate sectors, and brings a wealth of knowledge in nonprofit management, corporate and nonprofit governance, fundraising, performance assessment, leadership advisory services and policy research.

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