Charitable Planning Potpourri

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Charles A. Redd is a partner in the St. Louis, Missouri, office of the law firm of STINSON LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now Bank of America Private Bank).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar, the Illinois State Bar Association, The Bar Association of Metropolitan St. Louis and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as a member of the Advisory Committee for the Heckerling Institute on Estate Planning and is Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils and, in 2023, was named Distinguished Estate Planner of the Year by the Estate Planning Council of St. Louis. Mr. Redd is listed in The Best Lawyers in America and is nationally "Band 1" ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

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I. PROPOSED REGULATIONS PERTAINING TO DONOR ADVISED FUNDS

IRC Section 4966 defines donor advised funds, the permissible (*i.e.*, nontaxable) distributions that can be made from a donor advised fund ("DAF"), and the distributions that will result in tax if made from a DAF. The November 14, 2023 proposed regulations, Prop. Reg. Sections 53.4966-0 through 53.4966-6,[1] if adopted, would add additional detail to help define whether a charitable fund is a DAF, and create additional rules of the road for donors and advisors looking to make charitable gifts through donor advised funds ("DAFs") without causing tax.

A. Prop. Reg. Section 53.4966-1

The proposed regulations would add more defined terms. Many of them are plain text definitions, but several expand on the text of IRC Section 4966 (such as the definition of "disqualified supporting organization"). Below are definitions that add significant new detail.

- (c) Disqualified supporting organization
    - The proposed regulations adopt the definition from IRC Section 4966 and expand on the type of supporting organization over which the donor would be deemed to advise on distributions.
    - The supporting organization will be disqualified if the donor or related parties have the ability to force committee action, control a majority of the votes or have a veto power with respect to any action that significantly affects the organization's operations. This is a facts and circumstances test.
- (e) Distribution
    - The proposed regulations construe "distribution" as including payments, disbursements and transfers – not just gratuitous transfers.
- (f) Donor
    - The proposed regulations exclude public charities and government units from the definition of a donor; the proposed regulations do <u>not</u> exclude

[1] Prop. Reg. Sections 53.4966-0 through 53.4966-6, REG-142338-7, 88 Fed. Reg. 77942 (November 14, 2023).

private foundations and disqualified supporting organizations from the definition of a donor.[2]

- (h) Donor-advisor
    - Donor-advisors are not included in the text of IRC Section 4966 but under the proposed regulations are subject to most of the same tests and restrictions with respect to a DAF that a donor is.
    - A donor-advisor is a person to whom the donor (or another donor-advisor) delegates distribution or investment advisory privileges, not including someone who is an advisor to the sponsoring organization.
    - In some cases, this definition would also include a donor's investment advisor who advises on the investments of the DAF and does not advise on the investments of the sponsoring organization as a whole.
- (j) Related persons
    - A related person is a family member of the donor or an entity controlled 35% by the donor or the donor's family.

B. Prop. Reg. Section 53.4966-2

The proposed regulations would add detail regarding liability for the tax due on taxable distributions.

- IRC Section 4966 lays out the applicable taxes on taxable distributions, and the proposed regulations begin by restating those tax amounts and that the tax would be due from the sponsoring organization and the fund managers who knew about the taxable distribution.
- The proposed regulations expand on the knowledge requirement, stating that any fund manager who had sufficient knowledge to determine that a distribution was a taxable distribution and negligently failed to take corrective action would be as liable as a fund manager who had actual knowledge of the taxable nature of the distribution.

C. Prop. Reg. Section 53.4966-3

The proposed regulations would give a great deal more information regarding the definition of a DAF.

- IRC Section 4966(d)(2) defines a DAF, with certain exceptions, as being a "fund or account – (i) which is separately identified by reference to contributions of a

[2] *See* commentary introducing the proposed regulations, "Separate Identification by Reference to Contributions of a Donor or Donors," page 10.

donor or donors, (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor."

- (b) expands on (i) of the above:
    - The proposed regulations define "separately identified" as meaning that the sponsoring organization maintains formal records of a donor or donor's contributions to that certain fund or account.
    - If there is no formal record, the determination of separately identified would be a facts and circumstances determination.[3]
    - Tracking the contributions to their respective donors is sufficient for this test; commingling the contributions with other donors' funds won't cause a certain donor's funds not to be separately identified.
- (c) expands on (iii) of the above, adding a facts and circumstances test. The donor can fail to give actual advice and still be found to have the ability to give advice, and therefore have advisory privilege. The existence of advisory privilege includes the conduct, agreements and understanding of the donor and the sponsoring organization.[4]
    - There are also several special rules that deal with specific cases of multiple donors, corporate donors and advisory privileges on committees.
    - Earmarking a donation in advance does not create advisory privileges.
    - In general, the ability to serve on a sponsoring organization's committee that advises on distributions or investments is an advisory privilege, but there are exceptions to this general statement that apply to individuals appointed to committees of unrelated persons of a certain size when the individual is not a significant donor.

[3] Relevant facts would include: the fund reflects contributions and the dividends, interest, expenses, and gains and losses attributable to such contributions; the fund is named after a donor or related person; the sponsoring organization refers to the fund as a DAF; the sponsoring organization has an agreement or understanding in place with the donor that such account is a DAF; the donor receives statements related to the account; and the sponsoring organization generally gets advice from the donor or donor advisor before making distributions.

[4] Any of the following four facts are sufficient to determine that donor advisory privilege exists. None of these rights need to be actually exercised for such determination: (1) the donor is allowed to provide non-binding recommendations on the distributions from or investments in the fund; (2) there's a written agreement stating that the donor has advisory privileges; (3) the donor receives written or marketing materials from the sponsoring organization indicating that the donor can advise on distributions or investments; and (4) the sponsoring organization generally solicits advice from donors regarding distributions or investments.

D. Prop. Reg. Section 53.4966-4

The proposed regulations also would expand on the exceptions to the definition of a DAF.

- Funds that make distributions only to a single identified organization that is charitable or governmental are excluded from the DAF definition under IRC Section 4966. The proposed regulations clarify that, if the donor has advisory privilege for such identified charity (such as a board position) or receives more than an incidental benefit from the donation, this exception does not apply.

- Funds that make scholarship grants for study, travel, etc. are excluded from the DAF definition under IRC Section 4966, provided that none of the donor, the donor's appointees or related persons have direct or indirect control over who receives the grants. The proposed regulations elaborate on this, stating that the exception applies only if the donor and related parties lack the ability to force committee action, majority voting control and a veto power.

- There is also a new exception for IRC Section 501(c)(4) organizations where members of the organization who are also donors comprise the selection committee, but qualifying for this exception requires meeting six additional criteria. This provision was included based on commentary from groups like Rotary.[5]

- Funds for disaster relief that meet six criteria are excepted from the definition of a DAF.

E. Prop. Reg. Section 53.4966-5

The proposed regulations would add detail regarding the determination of a taxable distribution.

- The proposed regulations adopt the definition of a taxable distribution from IRC Section 4966, which is a distribution to an individual or to a person that is not for a purpose under IRC Section 170(c)(2)(B) or over which the sponsoring organization exercises expenditure responsibility.

- The proposed regulations add a rule that collapses multiple transfers if the end result of those transfers is to make a distribution that would have been a taxable distribution if made directly by the DAF.

- Distributions to non-charitable organizations are taxable unless the purpose is charitable and the sponsoring organization exercises expenditure responsibility under IRC Section 4945(h) (cross-referencing the private foundation regulations). There is also a requirement that the recipient organization agree not to use the funds

[5] *See* commentary introducing proposed regulations, "Exception for Certain Scholarship Funds Established by Certain Section 501(c)(4) Organizations," starting on page 27.

for distributions to individuals, the donor, the donor's related persons or an organization for an impermissible purpose.

- The proposed regulations give additional guidance for making non-taxable distributions under IRC Section 170(c)(2)(B); the distributions can be made:
    - To a charitable organization that is described in both IRC Section 170(b)(1)(A) and IRC Section 170(c)(2) (other than a disqualified supporting organization); this includes foreign charities.
    - To a United States governmental unit, agency or instrumentality thereof that is described in IRC Section 170(b)(1)(A)(v), IRC Section 170(c)(1), or IRC Section 511(a)(2)(B), as long as funds are used for public purposes.
    - To a foreign governmental unit, agency or instrumentality thereof that is described in Executive Order under 22 U.S.C. 288, as long as the purposes are those described in IRC Section 170(c)(2)(B).
    - To a foreign charity if it would qualify as a public charity in the United States; this is a good faith determination test and does not require expenditure responsibility if satisfied.
- A distribution that results in a benefit (beyond the merely incidental) to the donor or related person is deemed to be a taxable distribution. However, per the Notice of Proposed Rulemaking that accompanies these proposed regulations, investments and reasonable fees are not distributions.[6]

F. Prop. Reg. Section 53.4966-6

The applicability date for the proposed regulations is for taxable years ending after the Treasury publishes its adoption of the regulations in final form.

II. ANTICIPATORY ASSIGNMENT OF INCOME DOCTRINE

In *Hoensheid*,[7] the taxpayers, Scott and Anne Hoensheid got hit with capital gains tax imposed on stock they had gifted to a DAF and didn't even get a charitable deduction!

A. Facts and Salient Issues

Scott and Anne Hoensheid contributed appreciated stock in a closely-held corporation, Commercial Trading Steel Corporation ("CTSC"), to a DAF administered by Fidelity Charitable Gift Fund, a tax-exempt charitable organization under IRC Section 501(c)(3) that, as a sponsoring organization, administers DAFs. The contribution was made "near contemporaneously" with the selling of the stock to a third party at its appreciated value. The salient issues before the Tax Court were: (a) whether the appreciation in the stock's value should be taxed to the Hoensheids on the

[6] *See* commentary introducing proposed regulations, "Taxable Distributions," page 33.
[7] *Hoensheid v. Commissioner*, T.C. Memo. 2023-34 (March 15, 2023).

theory that the sale to the third party was "a virtual certainty" before the stock was contributed to the DAF[8]; and (b) whether, as a result of the contribution, the Hoensheids were entitled to an income tax charitable deduction.[9]

B. Taxpayers' Positions and Tax Court's Holdings

Regarding issue (a), the Hoensheids vigorously maintained that, since Fidelity Charitable had no legal obligation to sell the stock when it landed in the DAF, the anticipatory assignment of income doctrine didn't apply, and so any gain in the stock's value at the time of its contribution couldn't result in income tax liability for them. In support of this argument, the Hoensheids cited Rev. Rul. 78-197,[10] which established, as a "bright line" test for determining if a contribution of stock to a charity followed by a redemption of that stock from that charity should be respected for tax purposes, whether the charity was legally bound or could be compelled to surrender the stock for redemption.[11]

The Tax Court conceded the IRS hadn't established that Fidelity Charitable was legally obligated to follow through on the sale but stated that fact wasn't dispositive. Apparently because the *Hoensheid* facts involved a sale to a third party as contrasted with Rev. Rul. 78-197 which involved a redemption, and because revenue rulings aren't binding on federal courts in any event, the court felt it was free to apply a different analysis.

The court then engaged in a lengthy and detailed recitation of facts leading to its conclusion that, by the time the Hoensheids had contributed the stock to the DAF, everything of substance had occurred that would be necessary to bring the sale by Fidelity Charitable to finality. Judge Mega wrote: "We…find that none of the unresolved contingencies remaining on [the date of contribution of the stock to the DAF] were substantial enough to have posed even a small risk of the overall transaction's failing to close." From that conclusion, the die was cast: "We hold that petitioners recognized gain on the sale."

Regarding issue (b), the appraisal submitted to support the Hoensheids' claimed income tax charitable deduction was wholly insufficient and nothing short of a train wreck. The law requires a "qualified appraisal" prepared by a "qualified appraiser." Those terms are explicated in excruciating detail in the Internal Revenue Code and Treasury Regulations.[12]

The court enumerated the following appraisal deficiencies:

- It didn't include the required statement that it was prepared for federal income tax purposes;
- It stated an incorrect date for the contribution to the DAF;

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[8] The "anticipatory assignment of income" doctrine. *See, e.g., Helvering v. Horst*, 311 U.S. 112, 119 (1940); *Lucas v. Earl*, 281 U.S. 111. 115 (1930).
[9] The IRS didn't raise issue (a) until ten months after the Hoensheids had filed their petition in Tax Court on issue (b).
[10] Rev. Rul. 78-197, 1978-1 C.B. 83.
[11] *See Rauenhorst v. Commissioner*, 119 T.C. 157, 173 (2002), and *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F. 2d 1308 (8th Cir. 1975), *acq*., 1978-1 C.B. 2.
[12] *See* IRC Section 170(f)(11)(E) and Treas. Reg. Section 1.170A-13(c)(3).

- It included a premature appraisal date;
- It didn't sufficiently describe the valuation method;
- It wasn't signed by the appraiser or anyone from his firm;
- It didn't include the appraiser's qualifications;
- It didn't describe the CTSC stock in sufficient detail; and
- It didn't include an explanation for the specific basis for the appraisal.

The court the observed that the appraiser had no appraisal certifications and, by his own admission, performed appraisals "only once or twice a year" and so, obviously, doesn't regularly perform appraisals for which he receives compensation.

To no avail, the Hoensheids argued they were in substantial compliance with the qualified appraisal requirements or, if they weren't, had reasonable cause, due to their reliance on a professional advisor, for falling short of those rules.

The court disallowed the Hoensheids' claimed charitable deduction in its entirety.

III. TRUST DECANTING TO GRANT POWER OF APPOINTMENT FACILITATING DISTRIBUTIONS TO CHARITY

In *Horvitz*,[13] Lois Horvitz, a surviving spouse was the sole beneficiary for life of QTIP trusts. As such, she had the right to receive the entire net income and the potential to receive principal distributions pursuant to the Trustee's exercise of exceptionally broad discretion. For example, the Trustee was permitted to distribute principal to or for Lois for her "comfort or general welfare," to "serve estate or tax planning objectives" and to enable her to "engage in any other activity deemed by the Trustee to be in [her] best interests." Furthermore, the governing instrument specifically allowed the Trustee, when considering whether to distribute principal, to ignore whether Lois had other available financial resources.

The Trustee decanted the trusts, under Ohio statutory law, to confer on Lois a testamentary power to appoint trust property to a family foundation. Following Lois' death and the filing of a federal estate tax return, the IRS selected that return for examination and disallowed the estate tax charitable deduction claimed with respect to the value of trust property appointed to the foundation.

It's clear that the Trustee's broad discretion to distribute principal to or for Lois constituted an "absolute power to distribute principal" under Ohio's trust decanting statute.[14] Accordingly, the Trustee was empowered, by law, to confer a power of appointment on Lois via a decanting transaction.

[13] *Estate of Lois Horvitz v. Commissioner*, Docket No. 20409-19 (Settled April 6, 2023).
[14] *See* Ohio Rev. Code Ann. § 5808.18(A)(2)(a).

In its Opposition to [the estate's] Motion for Partial Summary Judgment, the IRS focuses on the estate's representation in its Motion that Lois "desired to leave additional assets to charity" and states that whether Lois had such a desire was a material fact remaining in dispute – thus precluding partial summary judgment. It's hard to see how whether Lois had charitable intent was in any way relevant to this case. It appears to have been undisputed that Lois possessed a completely valid, freely exercisable testamentary power of appointment and that she effectively exercised it.

The case was settled on April 6, 2023. The estate paid $71,830 and received a refund of $4,928,170.

IV. CONTINUING PROBLEMS WITH CHARITABLE REMAINDER TRUSTS

A. Charitable Deduction Denied Because CRAT was Improperly Administered

Atkinson v. Commissioner, 309 F.3d 1290 (11 Cir., October 16, 2002), *aff'g* 115 T.C. 26 (2000)

The U.S. Court of Appeals for the Eleventh Circuit affirmed the Tax Court's denial of an estate tax deduction for a charitable remainder annuity trust ("CRAT") that was not administered according to the terms of the trust.

1. *Facts*

Melvine Atkinson transferred stock valued at $4 million to a CRAT. The trust provided Atkinson with an annuity equal to 5% of the initial fair market value of the trust assets, to be paid in quarterly installments for Atkinson's life. On Atkinson's death, the trust was to pay the annuity to four individuals, but only if they each agreed to pay their share of estate taxes.

No annuity payments were actually made to Atkinson during her life. On Atkinson's death, the amount of the undistributed annuity was included in her estate, and the estate took a charitable deduction for the value of the remainder interest. Only one beneficiary, Mary Birchfield, elected to receive the annuity upon Atkinson's death. She filed a claim against the estate, alleging that she did not have to pay her share of the estate taxes because Atkinson promised her that she would not have to do so. Following a settlement of Birchfield's claim, the CRAT made annuity payments to Birchfield for a few years before she died.

The IRS disallowed the charitable deduction, determining that the annuity trust was not a valid CRAT because the trust failed to make the required annuity payments to Atkinson.

2. *Rulings of Tax Court and Eleventh Circuit*

The Tax Court agreed with the IRS, finding that the trust did not qualify as a CRAT. Because the IRS denied the estate's charitable deduction, the estate did not have enough money to pay both Birchfield's share of the estate taxes and Atkinson's administration expenses. Thus, the estate had to invade the CRAT to make up the difference.

The Eleventh Circuit affirmed the Tax Court's decision in favor of the IRS. The court found that a CRAT must be set up as such under IRC Section 664 and then comply with the

statutory requirements for CRATs throughout its existence to enable it to take a charitable deduction. The court stated that because the annuity trust failed to adhere to the CRAT requirements throughout its existence by failing to make annuity payments, no charitable deduction was available. Further, the trust impermissibly used CRAT assets to pay estate taxes.

B. Estate Denied Charitable Deduction Where Trust Failed to Qualify as a CRAT and Trust Was Not Judicially Reformed

Estate of Block v. Commissioner, T.C. Memo. 2023-30 (March 13, 2023)

1. *Facts*

Susan Block created the Susan Rubin Block Revocable Trust in 1997 and amended and restated it in 2015. Within the governing instrument of that trust, a subtrust, the Katz Trust, was to come into existence at her death for the benefit of her sister, Harriet Katz, then for the benefit of I.W. Katz (Harriet's spouse), and then for the Jewish Community Foundation of Greater Hartford, Inc. The trust instrument specified that the Katz Trust was to be a CRAT and that "an annuity amount" was to be paid to Harriet during her life (and then to I.W. if he survived Harriet) in an amount equal to the greater of all net income or $50,000. The Katz Trust was irrevocable; however, the instrument permitted the Trustee to amend the Katz Trust provisions as needed to ensure it qualified as a CRAT within the meaning of IRC Section 664(d)(1). The Trustee, though, was not allowed to change the annuity period, the annuity amount or the recipients of the annuity amount.

In 2016, Susan's co-executors filed a Form 706 deducting from the value of the gross estate the present value of the charitable remainder interest of the Katz Trust, which they calculated using $50,000 as the annuity amount and the life expectancies of Harriet and I.W. The IRS examined the estate tax return and issued a notice of deficiency based on disallowance of the claimed charitable deduction of $352,085 connected to the Katz Trust. Thereafter, the Co-Trustees of the Katz Trust amended its terms to provide for an annuity payment of $50,000 at least annually (and removed the "greater of all net income" option).

2. *Parties' Positions and Tax Court Holding*

The IRS asserted, and the Tax Court agreed, that the Katz Trust did not qualify as a CRAT because it violated the IRC Section 664 requirement that a CRAT annuity be a sum certain.

The estate's first counter-argument was that the Co-Trustees' amendment (changing the annuity amount to a flat $50,000) was a "qualified reformation."[15] However, because a qualified reformation isn't possible without a "reformable interest" and because the charitable remainder of the Katz Trust did not qualify as a reformable interest under the default rule,[16] the only option to qualify the remainder as a reformable interest was through a judicial proceeding.[17] However, that option was unavailable since the amendment was completed beyond

[15] *See* IRC Section 2055(e)(2)(B).
[16] *See* IRC Section 2055(e)(3)(C)(ii).
[17] *See* IRC Section 2055(e)(3)(C)(iii).

the 90-day period following the estate tax return due date, and the amendment hadn't been effectuated judicially (rather, it was instituted by the Co-Trustees alone).

The estate also argued that Rev. Proc. 2003-57[18] and Rev. Proc. 2003-59[19] permit a Trustee, by means of exercising a "Limited Power of Amendment" to amend the terms of a trust at any time, acting alone, without court involvement, to ensure it both qualifies as a CRAT and retroactively qualifies for an estate tax charitable deduction. The thrust instrument included language conferring such a power on the Co-Trustees. However, observed the court, one cannot the corollary provisions of the Revenue Procedures. One, in particular, is that the annuity amount, before amendment, must be a number no less than 5 and no more than 50 percent of the initial net fair market value of all property passing to the trust as finally determined for federal estate tax purposes. The court opined that an amendment that would be within the scope of the Revenue Procedures did not allow for corrections to "major, obvious defects," such as the Katz Trust's "greater of all net income or $50,000" provision.

The estate's last gasp was that it was clear from the trust instrument that Ms. Block the Katz Trust to be a CRAT, and the amendment just confirmed that notion. Essentially, the estate's position was that the "greater of all net income" provision was void from the start because that provision was incompatible with the requirement that the annuity amount be a "sum certain." Accordingly, concluded the estate, it wasn't even necessary to have a qualified reformation or a judicial proceeding to amend the trust instrument to cause the Katz Trust to qualify as a CRAT. Unmoved, the court disagreed that trusts can be considered CRATs when the noncharitable payment is not definitively a "sum certain" or "certain and unmanipulable." Thus, the court held that under a proper interpretation of IRC Section 664(d), the original Katz Trust was not a CRAT, and, because the Co-Trustees did not effect a qualified reformation, the estate tax charitable deduction was denied.

C. Charitable Remainder Trust's Status as Tax-Exempt Doesn't Carry Over to its Noncharitable Beneficiaries

Gerhardt v. Commissioner, 160 T.C. No. 9 (April 20, 2023)

The Gerhardts contributed highly appreciated property to CRATs. Gain wasn't recognized by the Gerhardts, and there was no basis adjustment, by reason of contribution of that property to the CRATs. The Trustees sold the property and invested the sales proceeds in single premium immediate annuities ("SPIAs") and designated the Gerhardts as the annuitants. In 2016 and 2017, the Gerhardts received annuities from the SPIAs. The bizarre position advanced by the Gerhardts before the IRS and the Tax Court, completely ignoring the dispositive effect of IRC Section 664(b), was that these annuity payments were tax-free.

The Tax Court wasn't impressed by the taxpayers' contention but may have been at least slightly amused:

> According to the Gerhardts, the Code also relieves them from paying tax on the distributions that were made possible by the CRATs' realization of the built-in gains. As they put it, "all taxable gains (on the sale of the asset[s contributed to the

[18] Rev. Proc. 2003-57, 2003-2 C.B. 257.
[19] Rev. Proc. 2003-59, 2003-2 C.B. 268.

> CRATs]) *disappear* and the full amount of the proceeds [is] converted to principal to be invested by the CRAT" …In the Gerhardts' view, "[i]t becomes obvious that Congress intended [this treatment] to promote charitable giving while offering large tax benefits as incentives." *Id.* at 7. The gain disappearing act the Gerhardts attribute to the CRATs is worthy of a Penn and Teller magic show. But it finds no support in the Code, regulations, or case law.

Gerhardt starkly illustrates a fundamental principle about CRTs that's frequently overlooked when blithely referring to CRTs as "tax-exempt." A CRT is tax-exempt much in the same way as a qualified retirement plan or an IRA is tax-exempt. When a CRT receives income that if received by an individual or a non-exempt entity would be taxable, it's non-taxable. Additionally, all transactions inside a CRT, with narrow, well-defined exceptions such as unrelated business taxable income, generate no income tax liability for the CRT. However, like an IRA or a qualified plan, when distributions are made from a CRT of amounts that would have been taxable income to the CRT when received if the CRT hadn't been tax-exempt, those distributions are taxable income, following the tier system laid out in IRC Section 664(b), in the hands of the recipients.[20]

D. Farmers' Corn and Soybeans Didn't Work for Funding a CRAT
Furrer v. Commissioner, T.C. Memo. 2022-100 (September 28, 2022)

The taxpayers transferred corn and soybeans to two CRATs. The IRS identified, and the Tax Court agreed that there were, two big problems precluding allowance of income tax charitable deductions for the present value of the remainder interests in the CRATs. First, the taxpayer didn't satisfy the substantiation requirements specified in IRC Section 170(f)(11)(C). In fact, they didn't even try. They didn't submit any appraisals at all to support their claimed deductions – let alone any "qualified appraisals," and they also failed to submit the required Form 8283. Second, the corn and soybeans were ordinary income property in the hands of the taxpayers since they were engaged in the farming business, and the corn and soybeans were grown on their farm. Their basis in the corn and soybeans was zero because they had fully expensed on their income tax returns all the costs they had incurred in growing the corn and soybeans. Under these circumstances, IRC Section 170(e)(1)(A) required that the deductible amount be reduced by the entire fair market value of the corn and soybeans – resulting in a deduction of zero.

Compounding the severity of this train wreck, the Trustee of CRATs sold the corn and soybeans and invested the proceeds in SPIAs. Like the Gerhardts, Mr. and Mrs. Furrer took the position that distributions to them from the CRATs were properly taxed to them under IRC Section 72. That position didn't avail the Furrers – not only for the same reason the Gerhardts gambit failed, *i.e.*, because IRC Section 664 overrides IRC Section 72, but also because IRC Section 72 allows an exclusion from income only to the extent a taxpayer as an "investment in the contract." Since the Furrers' and the CRATs' basis in the property whose sale proceeds were used to purchase the SPIAs was zero, neither the Furrers nor the CRATs had any investment in the contract.

[20] *See* IRC Section 664(b).

E. Proposed Regulations Declaring CRAT Scam as a Listed Transaction
Prop. Reg. Section 1.6011-15, REG-108761-22, 89 Fed. Reg. 20569 (March 25, 2024)

The facts of *Gerhardt* and *Furrer* obviously got the attention of the IRS, and the agency was displeased. Accordingly, Prop. Reg. Section 1.6011-15 provides that a CRAT transaction that is "substantially similar" to one that includes the following elements shall be considered a "listed transaction" and so must be disclosed:

- A settlor creates a trust purporting to qualify as a CRAT under IRC Section 664;
- The settlor funds the trust with property having a fair market value in excess of its basis (contributed property);
- The Trustee sells the contributed property;
- The Trustee uses some or all of the proceeds from the sale of the contributed property to purchase an annuity; and
- On a federal income tax return, the beneficiary of the trust treats the amount payable from the trust as if it were, in whole or in part, an annuity payment subject to IRC Section 72 instead of as carrying out to the beneficiary amounts in the ordinary income and capital gain tiers of the trust in accordance with IRC Section 664(b).

V. INTRODUCTION TO IRC SECTION 501(C)(4) "SOCIAL WELFARE" ORGANIZATIONS[21]

A. Exempt From Income Tax Even Though Not "Charitable"

Pursuant to IRC Section 501(a), an organization described in IRC Section 501(c)(4), like an organization under IRC Section 501(c)(3), is exempt from income tax. Among the types of organization described in IRC Section 501(c)(4) is any "organization not operated for profit but operated exclusively for the promotion of social welfare." Such an organization isn't exempt from income tax, however, if any part of its earnings inures to the benefit of any private shareholder or individual.[22] "An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community."[23] Notably, an organization may qualify under IRC Section 501(c)(4) even if it it's objectives aren't "for religious, charitable, scientific, testing for public safety, literary or educational purposes" and otherwise wouldn't qualify under IRC Section 501(c)(3). If the benefits generated by an organization are limited to its members, as opposed to members of the community

[21] For a comprehensive discussion and analysis of IRC Section 501(c)(4) organizations, *see* Bedingfield, "'Goodbye Chapter 42' – The New World of Social Welfare Philanthropy," 58 U. Miami Heckerling Institute on Estate Planning, Chapter 8 (2024 University of Miami).
[22] IRC Section 501(c)(4)(B).
[23] Treas. Reg. Section 1.501(c)(4)-1(a)(2)(i).

at large, it won't pass muster under IRC Section 501(c)(4) unless membership in the organization is open to the public.[24]

B. Permissible and Impermissible Activities

An organization may qualify as a social welfare organization under IRC Section 501(c)(4) even though it confers benefits on individuals so long as the private benefits are available to members of a "public" community or a community at large as opposed to members of a closed community such as a club.[25] Such an organization may engage in activities that involve championing a cause or promoting or influencing legislation but may not participate, directly or indirectly, in "political campaigns on behalf of or in opposition to any candidate for public office."[26] Additionally, an organization will not qualify under IRC Section 501(c)(4) if its primary function is "carrying on a business with the general public in a manner similar to organizations which are operated for profit."[27]

C. No Income Tax Deduction for Contributions

Although a social welfare organization under IRC Section 501(c)(4) is a tax-exempt entity for income tax purposes, such an organization isn't described or referenced in IRC Section 170(c), and so contributions to such an organization don't give rise to an income tax deduction for the contributing party under IRC Section 170(a). This is among the most important distinctions between IRC Section 501(c)(4) organizations and IRC Section 501(c)(3) organizations. However, because an IRC Section 501(c)(4) organization is tax-exempt, capital gains realized in connection with sales of property contributed to such an organization won't be subject to tax.[28]

D. Gift and Estate Tax Considerations

1. *Gift Tax*

A social welfare organization under IRC Section 501(c)(4), not being "charitable" in nature, isn't referenced in IRC Section 2522, and so no charitable deduction is available in respect of contributions to such an organization. That's the "bad news" on the gift tax front. The counter-vailing "good news," however, is that such contributions aren't treated for tax purposes as gifts at all.[29] An organization isn't required to file anything with the IRS in order to obtain status as qualified under IRC Section 501(c)(4), but, if a large contribution is to be made to the organization, it would behoove it voluntarily to file Form 1024-A to obtain an affirmative determination of such status. Otherwise, a very unpleasant gift tax surprise could result.

2. *Estate Tax*

If a donor to an IRC Section 501(c)(4) organization serves as a member, director, officer or in any way, alone or in conjunction with others, is in a position to designate who shall

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[24] *See, e.g.*, Rev. Rul. 75-286, 1975-2 C.B. 210, and Rev. Rul. 75-386, 1975-2 C.B. 211.
[25] Treas. Reg. Section 1.501(c)(4)-1(a)(2)(ii).
[26] *Id*.
[27] *Id*.
[28] But *see Hoensheid v. Commissioner*, T.C. Memo. 2023-34 (March 15, 2023).
[29] IRC Section 2501(a)(6).

enjoy or possess the organization's property or its income, inclusion in the donor's gross estate will be the result.[30] When contemplated within the context of a donor's contributions to an IRC Section 501(c)(3) organization, such a result isn't deleterious because of the offsetting estate tax charitable deduction ordinarily available under IRC Section 2055. However, with an IRC Section 501(c)(4) organization, such a result can be disastrous – a large, nondeductible increase in the value of the donor's gross estate with a corresponding increase in estate tax and no access to assets giving rise to the tax.

Among the strategies to avoid this problem, a couple are as follows:

- The donor could avoid being in a position to participate in decisions regarding deployment of the organization's income and/or principal (but could, if so desired, participate in the organization's investment and internal management decisions). If the donor is in an estate tax-sensitive position, he or she could resign from that position, but, for the resignation to have the desired effect, it would need to occur at least three years before the donor's death.[31]

- The governing instruments of the organization could provide that, at the donor's death and if or to the extent the value of its assets is included in the donor's gross estate, the organization will immediately be converted, or will terminate and all of its assets will immediately be distributed to, an organization that qualifies for the IRC Section 2055 deduction.

E. Additional Tax Considerations

Although a social welfare organization under IRC Section 501(c)(4) is a tax-exempt entity for income tax purposes (like an organization under IRC Section 501(c)(3)), it may be subject to a variety of other taxes, as follows:

- The tax on unrelated business income (UBTI) imposed by IRC Section 511;

- Taxes on excess benefit transactions imposed by IRC Section 4958;[32]

- The tax on covered employee remuneration in excess of $1 million and excess parachute payments to any covered employee imposed by IRC Section 4960; and

- The tax on political activity equal to the lesser of the organization's net investment income and the aggregate amount expended by the organization during the year on political activity imposed by IRC Section 527(f).[33]

[30] IRC Section 2036(a)(2).
[31] *See* IRC Section 2035(a).
[32] These taxes are actually imposed on "disqualified persons" and organization managers."
[33] *See* Bedingfield, *supra*, note 21.