

Professional Notes

SUMMER 2019

TAX & ESTATE PLANNING

Contributions to Donor-Advised Funds

Community foundations like The New York Community Trust are public charities that offer a broad range of giving possibilities including field-of-interest funds (which support a general area of interest such as the environment or education), unrestricted funds to improve the quality of life in a particular geography, designated funds (which support one or more specified organizations), and donor-advised funds. This edition of *Professional Notes* focuses on the donor-advised fund.

A gift to a donor-advised fund is a gift to a public charity because a donor-advised fund is, by definition, “owned and controlled” by a public charity. And for federal income tax purposes, this is good news, thanks to the highly favorable deductibility rules that apply to an individual’s lifetime gifts to public charities.

This issue of *Professional Notes* provides an overview of giving to public charities in general, with attention to special considerations that may apply to donor-advised funds. It also addresses other opportunities involving donor-advised funds, including as the recipient of grants from a private foundation (including the terminating grant of a foundation that is winding down), of lead payments from a charitable lead trust or the remainder of a charitable remainder trust, and of a bequest disclaimed by an individual. Finally, we discuss briefly the use of donor-advised funds when an intra-family gift is funded using a self-adjusting formula clause.

Written by Jane L. Wilton, General Counsel, The New York Community Trust

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2019 SERIES

Spring

**Donor-Advised Funds:
An Examination of Their
Popularity and Legal
Underpinnings**

Summer

**Contributions to
Donor-Advised Funds**

Fall

**Grants From
Donor-Advised Funds**

Lifetime Charitable Giving to a Donor-Advised Fund

Annual Limits on the Charitable Deduction.

Depending on the circumstances, an individual donor's charitable contributions may be deducted up to an aggregate annual cap of 50 percent of the donor's "contribution base," i.e., adjusted gross income computed without any net operating loss carryback.

Lower caps apply with respect to certain non-cash assets and certain types of charitable recipients. For example, an individual donor who in a particular year confines his or her giving to private non-operating foundations, or gifts of appreciated securities, will not be able to deduct more than 30 percent of his or her contribution base for that year. A corporation may not claim charitable deductions exceeding 10 percent of its annual taxable income. Charitable gifts in excess of applicable caps may be carried forward for up to five additional tax years after the year of the gift.

The bigger challenge to deductibility is the 2018 increase in the standard deduction for non-

AMT taxpayers. The donor who is not subject to the AMT will not realize any financial benefit from deducting charitable contributions unless his or her total itemized deductions exceed the standard deduction—in 2019, \$12,000 and \$24,000, respectively, for single taxpayers and for married taxpayers filing jointly.

Cash. Through 2025, a donor who only contributes cash to public charities (including donor-advised funds) and private operating foundations may deduct those gifts up to a cap of 60 percent of the donor's

contribution base. As a practical matter, this enhanced cap, which was increased from 50 percent beginning January 1, 2018, is illusory for donors whose charitable giving includes securities or other non-cash gifts or includes gifts to a private non-operating foundation or to a charitable remainder trust. For those donors, the real cap remains 50 percent of their contribution base.¹

Long-Term Appreciated Securities. When appreciated securities held for more than a year are donated to charity, the donor generally enjoys an income tax charitable deduction for the asset's fair market value *and* avoids tax on the capital gain. This is probably the best known and most widely used tax benefit of charitable giving. Where the recipient is a donor-advised fund, other public charity, or private operating foundation, the donor may use this deduction up to a limit of 30 percent of the donor's contribution base. By contrast, a donor of qualified appreciated stock to a private non-operating foundation may deduct the value of the gift only up to 20 percent of the contribution base.

Even with the lower deductibility thresholds that apply to gifts of appreciated stock, these assets are often the most tax-efficient choice for gifts to charity due to the donor's ability to avoid tax on the gain. Donors should, however, be mindful that the gifted assets should not be subject to an agreement to sell, in which event capital gains may be triggered and taxed to the donor.

Donors of appreciated securities may choose to deduct them at basis, so that the gift qualifies for the 50 percent cap usually used only for cash gifts.

Short-Term Appreciated Securities. Gifts of appreciated securities held for one year or less do not receive the same favorable tax treatment as gifts of long-term securities. Although the general rule is that the fair market value of contributed securities is deductible, the deduction is reduced by the

Alternative Minimum Tax and the Standard Deduction

Donors subject to the alternative minimum tax (the "AMT") often wonder if they can deduct their charitable gifts. Under current law, charitable contributions are not an item of tax preference and therefore are not disallowed as deductions for AMT taxpayers.

¹ The Joint Committee Blue Book to the 2017 Tax Cuts and Jobs Act suggests that the limit on the availability of the 60 percent cap was inadvertent, stating, "the 60-percent limit for cash contributions is intended to be applied after (and reduced by) the amount of noncash contributions to organizations described in section 170(b)(1)(A)." It is anticipated the provision may be fixed in a technical corrections bill.

Notes Professional

amount of gain that would be treated as short-term capital gain had the property been sold. Effectively, this means that a donor of short-term appreciated securities may deduct only the *lesser* of fair market value and basis.

Depreciated Securities. For the individual considering a gift of depreciated securities, it generally will be more advantageous to sell the securities and contribute the proceeds, rather than donate the securities. This is because the donor may deduct only the fair market value of a charitable gift of either long- or short-term depreciated securities, but the built-in loss on the securities is not deductible. A realized loss on a sale, on the other hand, may be used to offset realized gains on other assets—and the loss may be carried forward to the extent it cannot all be used in the year realized.

IRA Assets. The individual retirement account (IRA) charitable rollover allows individuals age 70-½ or older to transfer up to \$100,000 annually from an IRA to eligible charities on a tax-free basis. The distribution is excluded from income, but it counts toward the account owner's required minimum distribution. Because an IRA charitable rollover is not included in income, there is no charitable deduction, making this treatment especially appealing to the non-itemizer. Unfortunately, this treatment is not available if the IRA distribution is contributed to a donor-advised fund or a private non-operating foundation; instead the donor will recognize the distribution in income and have to take a charitable deduction, assuming he or she itemizes.

Real Estate. Real estate may be a major asset of a donor and therefore a logical candidate for a charitable gift to a donor-advised fund. But as an asset class, real estate tends to be illiquid and presents other planning challenges as well, such as potential environmental liabilities, the costs of marketing and sale, and (until the property is sold) the costs of maintenance, taxes, insurance, and the like. Real estate generally is a capital asset

and qualifies for a fair market value charitable deduction if it has been held for more than one year and is given to a donor-advised fund, other public charity, or private operating foundation. However, depreciation recapture rules may reduce the amount of the deduction. For more information about gifts of real estate, see nycommunitytrust.org/charitable-gifts-of-real-estate.

Cooperative apartments may seem like real estate, but are in fact shares of stock in a cooperative housing corporation coupled with a proprietary lease. They present their own issues, most particularly the rules of the cooperative corporation, which may not permit charity to be a shareholder.

Art. Art held by a collector generally will be capital gain property and, more specifically, will be categorized as a “collectible.” As a collectible, realized gain on the disposition of art is taxed at a higher federal rate (28 percent) than other capital assets, and in this respect, it is among the most appealing capital assets to give to charity.

However, there is a major “catch” for a donor desiring to take a fair market value charitable deduction for a work of art: the fair market value deduction is available only if the donor reasonably anticipates that the art will be used for the recipient's charitable purpose (e.g., exhibited to the public as part of its charitable and educational mission). This means that art typically is a suitable gift to a museum, or maybe to a university or an art school, but is not ideal for a donor-advised fund, which would typically sell the art and leave the donor with a deduction only for his or her basis.

There may be circumstances where it makes sense to give art to a donor-advised fund even

Qualified Appraisals

Publicly traded stock is one of the few types of property deductible at fair market value for which the IRS does not require a “qualified appraisal”. Also excluded from the “qualified appraisal” rules are shares of non-publicly traded stock if valued at \$10,000 or less and other property (e.g., art and real estate) if valued at \$5,000 or less. Anyone contemplating a gift of property, other than cash or publicly traded securities, would be well-advised to become familiar with the “qualified appraisal” rules and IRS Form 8283. Failure to obtain a required appraisal will disqualify a charitable deduction, even if the failure was the result of a good faith mistake.

Notes

though the “related use” requirement cannot be met. For example, if the artwork has not greatly appreciated or if the donor’s main objective is to use a highly appreciated work of art to fund a charitable remainder unitrust that will generate a stream of income for the donor, with the remainder going to charity, including a donor-advised fund.

Excess Business Holdings Rules

If a contemplated charitable gift of securities will result in a donor-advised fund (or a private foundation or Type III supporting organization) owning more than two percent of the voting or non-voting shares or units of a corporation, partnership, company, or other entity, the donor and the recipient charity will need to engage in a thorough excess business holdings analysis. (There is some question of whether related party rules would require aggregation of related donor-advised funds or private foundations for purposes of applying the two percent threshold.) The excess business holding rules impose an excise tax of ten percent on the excess business holdings of a “business enterprise.” The tax increases to 200 percent if the excess business holdings are not reduced.

If the entity is not a business enterprise—i.e., it derives at least 95 percent of its gross income from passive sources (dividends, interest, royalties, capital gains)—shares or units of the entity are not subject to the excess business holdings rules. But if the entity is a business enterprise and the holdings of the donor-advised fund will be above the *de minimus* two percent level, the tax on excess business holdings can be avoided only if the aggregate holdings of the donor-advised fund, the donor and certain other disqualified persons amount to 20 percent or less of the voting stock, profits interest, or beneficial interest—unless it can be demonstrated that control of the business enterprise rests with third parties, in which case the threshold increases to 35 percent. (There is another exception to the 20 percent rule, under a special rule created in 2017 to deal with the Newman’s Own food company owned by the Newman’s Own Foundation. But

this exception is available only in very unusual circumstances.)

There is a five-year grace period for donated assets that are excess business holdings, but when that period ends, holdings ordinarily must be within permissible limits in order to avoid this tax. A plan should be in place from the outset to monitor the aggregate holdings of donor-advised funds and disqualified persons, and to bring excess business holdings down to a level where they won’t be taxable.

Notably, these rules apply only to donor-advised funds at a public charity. Donors to a field-of-interest fund or a designated fund at a community foundation need not be concerned about the excess business holdings rules.

Grants by Private Foundations to Donor-Advised Funds

Grants by a private foundation to a donor-advised fund are qualifying distributions—that is, they count toward the foundation’s so-called five percent pay-out requirement. As a result, a private foundation may find that a donor-advised fund is a complementary adjunct to the foundation’s usual philanthropy. With a fund at The New York Community Trust, a private foundation can work with our professional grant staff to develop a grantmaking program that complements or expands the foundation’s own grantmaking. A fund in The Trust may be used to support different causes than those typically associated with the private foundation or it may serve as a vehicle to engage the next generation

An Ideal Asset to Bequeath to a Community Foundation

In terms of testamentary planning, IRA assets are among the smartest assets to leave to charity, including a donor-advised fund. An individual who inherits an IRA or other “income in respect of a decedent”—i.e., income that would have been taxable to the decedent had he lived—must pay income tax on the gift, even if the value of the asset was subject to estate tax in the decedent’s estate. Thus, if the decedent’s assets were in excess of the unified credit for gift and estate tax (\$11.4 million for a decedent dying in 2019), the IRA assets end up being taxed twice; even if the assets of the estate are below that threshold, the IRA will be subject to income tax. But if the IRA is designated directly for charity, the estate will claim an estate tax charitable deduction and charity will receive the IRA assets without tax due to its tax-exempt status. Unlike the rule for lifetime gifts of distributions from an IRA, IRA assets left to a donor-advised fund at death qualify for advantageous treatment.

as donor advisors, so that they can begin to learn about charitable giving.

If a private foundation becomes too expensive or an administrative burden, or if family members no longer wish to work together, it may be time to terminate the foundation and transfer its assets to one or more donor-advised funds. The Internal Revenue Code permits a private foundation to terminate its status tax-free upon transfer of all of its net assets to one or more organizations described in Code Section 170(b)(1)(A) (other than in clauses (vii) and (viii)) that have been in existence for at least 60 months. The New York Community Trust and most public charities that hold donor-advised funds meet this definition and are an attractive alternative for the terminating grant of a private foundation. As an additional benefit, the donor-advised fund that receives a private foundation's terminating grant can be named to recognize the foundation, thus perpetuating the name of a beloved founder or a distinctive philanthropic legacy.

For more information about terminating a private foundation, see nycommunitytrust.org/terminating-private-foundation.

Lead and Remainder Trust Distributions to a Donor-Advised Fund

A donor-advised fund can be the lead beneficiary of a charitable lead trust. To qualify for the income tax deduction and avoid inclusion of the trust property in the grantor's estate, the individual creating a charitable lead trust must name the charitable beneficiary or beneficiaries when the trust is created or grant someone else the power to decide which charities will receive the lead trust distributions. The IRS has ruled privately that the grantor of a charitable lead trust may designate a donor-advised fund at a public charity as the charitable beneficiary of a charitable lead trust. See Private Letter Ruling 198146072. Even if the grantor is the advisor on the fund, he or she is not considered to have maintained control over distributions.

A donor-advised fund may also be designated to receive all or a portion of the remainder of a charitable remainder trust.

Qualified Disclaimers in Favor of a Donor-Advised Fund

A legatee who disclaims a bequest in favor of charity usually intends that the disclaimer will enable the disclaimed property to qualify for the estate tax charitable deduction. However, if the disclaimed property will pass to a private foundation or other charity where the disclaimant is a board member, the disclaimer may not be a qualified disclaimer—and the charitable deduction may be lost—unless the disclaimer beneficiary changes its governance to exclude the disclaimant from decisions about the disclaimed property. However, in Private Letter Ruling 200518012, the IRS ruled that a disclaimer in favor of a donor-advised fund, as to which the disclaimant would serve as donor advisor, was a qualified disclaimer, thereby saving the charitable deduction.

Formula Clauses that Incorporate a Donor-Advised Fund

Intrafamily transactions often are structured to minimize or avoid estate and gift tax. One way this is accomplished is through an arrangement—commonly, an outright gift, a transfer to a grantor retained annuity trust, or a sale to an intentionally defective grantor trust—designed to transfer value to a younger generation without incurring gift or estate tax. A common issue in transactions of this nature is uncertainty about the value of the property or interest in property that is being transferred. If the IRS successfully contests the value the taxpayer has claimed, there could be gift tax liability, as well as interest and penalties.

To address this issue, estate planners commonly use “formula clauses” designed to ensure that the percentage of an asset transferred to family members (or trusts for their benefit) is exactly equal to a specific dollar value, often the amount of a taxpayer's remaining exemption from gift and estate tax.

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

between the two classes of donees by the use of a formula that states the portion of the interest having a defined dollar value (e.g., \$11.4 million “as finally determined for federal gift-tax purposes”) will pass to the family members (usually one or more long-term family trusts) and the balance to the charitable donee (commonly a donor-advised fund at a community foundation). Under a variation of this technique, the portion passing to the family donees is transferred in exchange for a promissory note from them. In either case, because what passes to the family donees is limited to a fixed dollar amount, even if a higher value for the 49 percent interest is successfully asserted by the IRS upon an audit of the transaction, their share is designed to remain valued at only \$11.4 million under the formula clause, and any “excess” value will accrue to the charity. The donor-advised fund is a smart choice in such cases because it does not restrict the gift to a single charity.

The IRS and Congress have expressly allowed the use of formula clauses in certain gift and estate tax contexts, and courts have affirmed the strong public policy supporting their use where the non-taxable beneficiary in the formula arrangement is a charitable organization, such as a donor-advised fund at a community foundation.

Conclusion

Donor-advised funds have soared in popularity in the past 20 years, and one reason is that they are efficient and effective in so many situations. No consideration of philanthropic choices is complete unless it includes the donor-advised fund as one of the leading options. The New York Community Trust welcomes your questions about the ways a donor-advised fund, or another charitable fund, can be of use to you or your clients, friends, or family.

For further reference, see:

I.R.C. Sec. 170(b)(1)(A): Deductibility of gifts to public charities

I.R.C. Sec. 170(b)(1)(C): Special limitations with respect to certain capital gain property

I.R.C. Sec. 170(e)(1): Certain contributions of ordinary income and capital gain property

I.R.C. Sec. 507(b)(1)(A): Private foundation terminating distributions

I.R.C. § 4943: Excess business holdings
PLR 198146072

PLR 200518012

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

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

Bedingfield and Dempze, *The Disappearing 60% Deduction—New Charitable Limits Are Not As Generous As They Appear*, Taxation of Exempts, Sept/Oct 2018, p. 36.

Joint Committee on Taxation, General Explanation of P.L. 115-97, 2017 Tax Cuts and Jobs Act (December 20, 2018), <https://www.jct.gov/publications.html?func=startdown&id=5152> at 51.



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



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



210 North Central Avenue, Ste. 310
Hartsdale, NY 10530
(914) 948-5166
wcf-ny.org

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