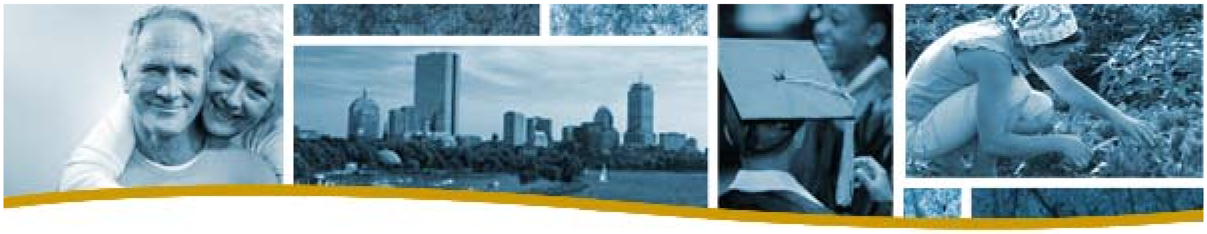

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A GUIDE TO CHARITABLE GIVING FOR PROFESSIONAL ADVISORS

Creating Flexibility in Charitable Planning in Uncertain Economic Times

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The roller coaster financial markets over the past few years and the unprecedented series of changes to the gift and estate tax laws have presented significant challenges to estate planning attorneys and their clients. For clients wishing to include charity, as well as family, in their estate plans, understanding what will likely be available in the estate to achieve family and charitable goals is crucial to designing a plan to implement client wishes. With the volatility in both the markets and estate planning laws, prediction (if ever possible) has become more difficult. Planners therefore must look to estate planning strategies that build flexibility into the estate plan to permit a "second look" at the plan at the time of death to apportion benefits among family and charity. Utilizing these strategies can give clients the peace of mind that their families will be left the resources they need, while also providing a vehicle for charitable goals to be achieved. Two of these strategies, disclaimer planning and formula clauses, will be discussed in this article.

Qualified Disclaimers

One method of incorporating charitable planning into an estate plan in a way that can take into account the financial circumstances of the non-charitable beneficiaries at the death of the donor is to give a non-charitable beneficiary the right to divert a portion or all of what he or she would otherwise receive to charity through a qualified disclaimer. A disclaimer, simply put, is a refusal to accept a benefit conferred by gift or bequest. Disclaimer planning to benefit charity therefore requires a plan that is constructed so that charity is the beneficiary that would receive any property that is disclaimed.

The basic design of a bequest that anticipates the possibility of a disclaimer in favor of charity would be as follows:

"_______ to A, and to the extent A makes a qualified disclaimer, to Charity B."

Such a design creates flexibility in charitable giving because the beneficiary can decide based upon the circumstances at the time of the testator's death what part, if any, of the bequest should go to charity and further whether disclaimer is the best way to direct the desired property to charity. For example, if the beneficiary makes the qualified disclaimer, the resulting bequest to charity of the disclaimed property will qualify for the federal estate tax charitable deduction just as if the decedent had made the bequest directly to charity (see Treas. Reg. §20.2055-2(c)(1)(i)), while the disclaimant will not be treated as having made a gift of the disclaimed property (IRC §2518(a)) . The benefits of this approach to making the charitable gift is that there will be no estate taxes on the disclaimed property, and 100% of it will pass to charity. On the other hand, if the beneficiary accepts the gift, it will be subject to estate tax, but when the beneficiary makes a gift to charity, he or she will be entitled to an income tax deduction for the charitable gift. So even if a beneficiary is willing to make a gift to charity, he or she should consider whether the property will be subject to estate tax and the level of the estate tax and disclaim only if the resulting estate tax charitable deduction is more valuable than the income tax charitable deduction the beneficiary would receive if he or she were to accept the bequest and then separately gift the property to the charity.

This trade-off between the estate tax and the income tax means that it will usually not make sense for a US citizen surviving spouse to disclaim in favor of charity, because accepting the bequest would not subject the property to immediate estate tax. If the surviving spouse would like a portion of what he or she receives to pass to charity, then assuming that the surviving spouse has the freedom to donate the property to charity (either because it has been left to the spouse outright or he or she can receive the property outright through the terms of a marital Trust), a direct gift by the surviving spouse could produce an income tax charitable deduction that would be lost if the property reached the charity through a disclaimer, and without any off-set in terms of an estate tax benefit.

For a beneficiary to make a qualified disclaimer in favor of a charity under IRC §2518(b), the following requirements must be satisfied:

- The refusal to accept the interest in property must be irrevocable and unqualified;
- The refusal must be in writing;
- The written refusal must be delivered to the property title holder (typically the executor of the decedent's estate, the trustee of the revocable trust holding the property, or the administrator of retirement benefits being disclaimed) within 9 months of the decedent's death;
- The disclaimant has not accepted the disclaimed property or any of its benefits; and
- The disclaimed property passes without any direction by the disclaiming party.

In addition, under IRC §2055(a), the complete termination of a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised and before the due date for filing the federal estate tax return (including extensions) will be treated as a qualified disclaimer for purposes of determining whether the resulting transfer qualifies for the estate tax charitable deduction.

The requirement that the disclaimant cannot direct the disposition of the disclaimed property needs to be taken into account in designing the disclaimer, since this requirement can be violated in a number of ways. For example, the IRS has interpreted that requirement to mean not only that a beneficiary cannot direct which charity will receive the disclaimed property, but also that a beneficiary cannot participate in deciding what a specified charity will do with the disclaimed property in furtherance of its charitable purposes. Thus in Rev. Ruling 72-552, a disclaimer by the president and director of the charity in favor of that charity was held not to be qualified because the disclaimant in his roles with the charity could participate in deciding what the charity would do with the disclaimed property. In such a situation, if the disclaiming person also irrevocably agrees not to participate in such decisions with respect to the disclaimed property, a qualified disclaimer can still occur (see e.g. PLR 200744005).

Similarly, if disclaimed property is to pass under the terms of an estate plan to a private foundation as to which the disclaimant is an officer or director, the disclaimant cannot participate in the disposition of the disclaimed funds.

The IRS has ruled privately, however (see e.g. PLRs 200518012 and 9532027), that a qualified disclaimer can be made in favor of a donor advised fund on which the disclaiming person is the advisor on how the fund should distribute its assets because ultimately it is the fund and not the advisor who has final say on how the fund's assets are to be distributed. These private letter rulings provide a significant opportunity for disclaimer planning, where a non-charitable beneficiary can decide to divert a portion of what he or she would otherwise receive, leaving it to pass to a donor advised fund, which can serve as the vehicle for accomplishing the disclaimant's philanthropic goals.

Flexibility is also provided by the fact that a beneficiary need not disclaim all of the bequest. Indeed, qualified disclaimers can be made with respect to (i) a fraction or percentage of what has been bequeathed (Treas. Reg. §25.2518-3(b)), (ii) a specific pecuniary amount out of a bequest (Treas. Reg. §25.2518-3(c)), or (iii) only a part of severable property such as would be involved in, e.g., the disclaiming of some shares of stock specifically bequeathed while accepting the remaining shares (Treas. Reg. §25.2518-3(a)(ii)). In addition, if the disclaimant itself is a trust, the disclaimer can be made by the trustee of the trust, although the trust instrument should specifically provide that the trustee can do so. Finally, if the identity of the charity or charities cannot be determined before the death of the decedent, the decedent may leave the choice of which charities shall benefit from the disclaimer to anyone other than the disclaiming party.

In addition to the purposeful incorporation of disclaimer planning into an estate plan, disclaimers can be used in other ways to accomplish estate and philanthropic planning goals. For example, in PLR 9827010, the IRS permitted a reformation of a trust that otherwise would not have qualified for an estate tax charitable deduction only after a qualified disclaimer made the trust reformable. In that ruling, the IRS first ruled that an individual bequeathed the lead interest in a trust could make a qualified disclaimer of just the annual cost of living adjustments to that lead interest because the adjustment right constituted "a separate interest in property" that could be disclaimed under Treas. Reg. §25.2518-3(a)(1)(i). Because the disclaimer was allowed, the IRS then went on to rule that the resulting lead interest, without the cost-of-living adjustments, could be reformed under IRC §2055(e)(3) into a charitable remainder annuity trust the remainder in which would qualify for the estate tax charitable deduction.

Formula Bequests to Charity at Death

Determining the desired balance between providing for loved ones and giving back to the community is often an important aspect of the estate planning process. Clients often consider this subject in light of the "snapshot" of their assets at the time the planning is being done. There is always an element of uncertainty as to how the client's financial circumstances might change over time, and this concern has recently been intensified by the roller coaster economy of the past few years.

The use of formulas in estate plans can provide flexibility in light of changing financial circumstances. Defined at its most abstract level, a “formula bequest” is just a bequest the specifics of which cannot be fully known until, at the earliest, the death of the testator. Under such a definition, basically all bequests other than a specific bequest of identified property (e.g. IBM stock; wedding ring; residence) or a pecuniary bequest of a specified amount (e.g. $100,000) are formula bequests. Formula bequests create flexibility because they automatically adjust to the preferred result for the actual circumstances at the testator’s death.

Formula bequests to charity differ from other formula bequests only in that the draftsperson must take care that the bequest sufficiently defines what is to pass to charity as of the death of the testator to qualify for the federal estate tax charitable deduction. The more certain the charity will benefit, and the more ascertainable the amount that must pass to charity, the more likely that the deduction will be upheld. (For a fuller discussion of this point, see e.g. Beckwith and Allan, 839-2nd T.M., *Estate and Gift Tax Charitable Deductions*, at IV.A.2.). In addition, the available estate tax charitable deduction will be reduced by any death taxes or transmission expenses allocated and/or apportioned to the charitable bequest (Treas. Reg. §20.2055-3). For this purpose, transmission expenses are estate administration expenses “that would not have been incurred but for the decedent’s death and the consequent necessity of collecting the decedent’s assets, paying the decedent’s debts and death taxes, and distributing the decedent’s property to those who are entitled to receive it.” (Treas. Reg. §20.2055-3(b)(ii)).

Here are some examples of the basic design of potentially useful formula bequests to charity.

- X% of residue to Charity A (the formula can specify whether the charity’s percentage should be calculated before or after estate taxes)
- Smallest amount (or % of residue) required to minimize federal and state estate tax to Charity A
- $X less any amounts paid during testator’s lifetime to same charity to Charity A
- Any remaining portion of lifetime pledge by testator still unpaid at testator’s death to Charity A
- First $X to Charity A; next $Y to issue; balance split on some percentage basis between Charity A and issue

If the formula used turns in part on the existence of a federal estate tax and/or determination of value for federal estate tax purposes, given the recent experience in 2010 with respect to that tax, consider drafting into the formula what should happen in the alternative should there be no federal estate tax at the death of the testator. Also the use of caps and floors for a bequest to charity could be considered in many situations where the formula result will depend in part on some especially unpredictable aspect of the situation at the testator’s death, such as, e.g., the amount of the applicable exclusion amount under the federal estate tax at the time of the testator’s death.

Conclusion

Building flexibility into the estate plan through disclaimer planning and formula bequests can be valuable tools in accomplishing clients’ family and charitable goals in these uncertain times. These strategies permit clients to continue to include charitable bequests in the estate plan while achieving the balance between benefiting charity and family with which the client feels most comfortable.

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