PITFALLS AND LANDMINES:
HOW TO NAVIGATE THE GIFT PLANNING PROCESS SUCCESSFULLY

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Dallas Council of Charitable Gift Planners

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This presentation will use a case study format to help the gift planner recognize and analyze issues that affect the structure, implementation and administration of planned gift arrangements. The cases will focus on issues that are often overlooked by gift planners and rules that are misapplied in the planning and implementation of gifts. This presentation will equip participants with the knowledge to identify potential mistakes and problems that can lead to serious consequences for charity and donor.

MR. & MRS. THURSTON HOWELL, III FLIP-CRUT

Facts:

- Donors want to establish a charitable remainder unitrust, to be funded with highly appreciated, closely-held securities.
- Husband Donor is nearing retirement from the company and is one of three shareholders.
- Corporate shares are subject to a buy-sell agreement which gives the company a right of first refusal and contains provisions for determining the value at which an individual shareholder may transfer shares. The agreement does not contemplate a charitable gift of the shares.
- The company plans to redeem the shares at a value of $14 per share, pursuant to the terms of the buy-sell agreement.
- Donors plan to claim a deduction based upon the value of their shares as determined under the buy-sell agreement.
- Donors assure Trustee that the company will offer to redeem the shares after the trust is funded.

Issues:

- Redemption Process & Self Dealing
- Qualified Appraisal Rules
- Prearranged Transaction
- Unrelated Business Income

Redemption Process & Self Dealing: A charitable remainder trust which complies with IRC § 664 and for which a deduction is allowed under IRC § 170 is a "split interest trust" described in IRC § 4947(a)(2), thereby making it subject to the self dealing rules under IRC § 4941. Specifically, IRC § 4941(d)(2)(F) imposes certain restrictions regarding redemptions of closely-held stock from closely related parties. The tax regulations which speak to this issue provide that a redemption of closely-held shares held by a charitable remainder trust will not result in a self-dealing transaction so long as all the securities of the same class as that held by the trust are subject to the same terms of redemption and such terms provide for receipt by the trust of no less than fair market value. Treas. Treas. Reg. § 53.4941(d)-3(d). The regulations further state that all of the securities are not subject to the same terms unless the corporation makes a bona fide offer on a uniform basis to the trust and every other person who holds such securities. Id.

Qualified Appraisal Rules: In order to receive an income tax charitable deduction for their gift, the Donors must comply with certain appraisal requirements. The fair market value of the stock on the date of the gift must be determined by a "qualified appraisal" that follows all the rules set by the IRS. Treas. Reg. § 1.170A-13(c). Specifically, the qualified appraisal rules apply to gifts of property (other than money and publicly traded securities) if the value claimed or reported for the property is in excess of $5,000. Treas. Reg. § 1.170A-13(c)(1)(i).

Note: A special rule exists for gifts of nonpublicly traded stock. If the claimed value of the stock exceeds $5,000 but is less than $10,000, the Donors will not be required to obtain a qualified appraisal. Rather, they will be required to attach a partially completed appraisal summary form (Form 8283, Section B, Parts I and II) to the tax return on which the deduction is first claimed. Treas. Reg. § 1.170A-13(c)(2)(ii).

The sole purpose of the appraisal is to allow the Donors to obtain their income tax charitable deduction, and the IRS will not allow a deduction without this appraisal. Accordingly, the Donors and their advisors bear the responsibility to obtain the qualified appraisal and to ensure that the appraisal is properly completed in a timely fashion and meets all of the requirements for qualification. While the Charity may be able to provide helpful information about the qualified appraisal rules, the final determination of the sufficiency of the appraisal rests with the Donors and their advisors.

The appraisal must be prepared no sooner than 60 days prior to the date of gift; however, the Donors are not required to have the appraisal in hand until they actually file the income tax return on which they will first claim the deduction. Treas. Reg. § 1.170A-13(c)(3)(iv)(B). Nonetheless, before the trust irrevocably receives these shares of stock from the Donors, it is important to understand the interplay between the appraised value of the stock that will determine the amount of the Donors' charitable deduction and the value at which the company will redeem the shares.

If the Donors establish the trust and later obtain a qualified appraisal that places a higher value on the shares than $14 per share and subsequently claim a deduction based upon that higher value, the IRS could question the validity of the deduction amount. When claiming the deduction, the Donors must attach an appraisal summary (found on Section B of IRS Form 8283) to the income tax return on which they first claim the deduction. Treas. Reg. §1.170A-13(c)(2)(i). The appraisal summary must be signed and dated by the donee charity (or the Trustee of the charitable trust), be signed and dated by the qualified appraiser, and state the appraised fair market value of the property on the date of contribution. Treas. Reg.

§1.170A-13(c)(4). Subsequently, should the Trustee sell, exchange, or otherwise dispose of any property for which the Trustee signed an appraisal summary within three years of the date of gift, the Trustee must then file an information return (IRS Form 8282) to report the amount received on the disposition. IRC § 6050L(a)(1). Should the amount claimed by the Donors as a deduction (based upon the value reported on Form 8283) significantly exceed the amount received by the Trustee to dispose of the property (as reported on Form 8282), the IRS could have grounds to question the validity of the Donors' claimed deduction.

In addition, such a discrepancy between the appraised value of the shares (and the resulting deduction) and the amount at which the shares are subsequently sold by the charitable trust could lead the IRS to determine that a self-dealing transaction occurred. As explained above, the charitable trust must receive no less than fair market value for the shares upon disposition in order to avoid a self-dealing transaction. Treas. Treas. Reg. § 53.4941(d)-3(d). Should the qualified appraisal show that the fair market value of the stock is greater than the $14 per share allowed under the buy-sell agreement, the IRS could establish that a self-dealing transaction has occurred, which could result in the imposition of sanctions under IRC § 4941.

It is also important to note that if the Donors hold less than a full ownership interest in the company, the appraised value of the Donors' stock may be discounted. Typically, an ownership interest in a business that represents less than full ownership will be discounted from 30 percent to 40 percent when appraised. This is important to remember because the charitable deduction will be calculated using this discounted appraised value while the company's calculation of the value of its stock may not reflect such a discount.

Prearranged Transaction: A prearranged transaction, formally known as a "step transaction", occurs when a series of separate and independent steps are treated as a single transaction if such steps are "in substance integrated, interdependent, and focused upon a particular result." *Esmark v. Commissioner*, 90 T.C. 171 (1988). When applied, the step transaction doctrine dictates that two or more ostensibly independent transactions (usually the gift of an appreciated asset followed by a subsequent sale of the asset by charity) are consolidated for tax purposes. This can happen when, under the facts and circumstances surrounding the gift, the donee charity is obligated to sell the gifted property to a purchaser that was prearranged by the donor prior to the gift. Hopkins, The Tax Law of Charitable Giving § 6.8 (John Wiley & Sons 1993). When this situation occurs, the IRS will view the transaction as a sale of the property by the donor to the third-party purchaser and a subsequent gift of the sales proceeds to charity, causing the donor to recognize the taxable gain from the sale of the gifted property. *Martin v. Machiz,* 251 F. Supp. 381 (D. Md. 1966).

In *Palmer v. Commissioner*, 523 F.2d 1308 (8^{th} Cir. 1975), a taxpayer with voting control of both a corporation and a tax-exempt private foundation donated shares of the corporation's stock to the foundation and subsequently caused the corporation to redeem the shares from the foundation, pursuant to a prearranged plan. The United States Tax Court treated the transaction according to its form because the foundation was a legitimate tax-exempt entity, the transfer of stock to the foundation was a legitimate gift, and the foundation was not obligated or required to redeem the shares at the time they were received. In a subsequent revenue ruling, the Service acquiesced to the *Palmer* ruling, stating that "[t]he Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197, 1978-1 CB 83.

In the case at hand, the provisions of the governing buy-sell agreement gave the corporation a right of first refusal to purchase any outstanding shares from an existing shareholder. However, the corporation did not have any right or authority to compel the charitable trust to surrender or sell the gifted shares. In any similar circumstance, great care must be taken to assure that any documentation which governs the transfer of shares among the donor, the donee charity (or charitable trust), and any other party must not be drafted so as to create an obligation on the part of the donee charity to sell the gifted property to a purchaser that was prearranged prior to the gift.

Unrelated Business Income: Generally, income from closely-held securities in the form of dividends or capital gain is considered "passive income" and not subject to the unrelated income tax. IRC §§ 512(b)(1), (2), (3), and (5). However, income derived from a controlled corporation may be taxable. IRC § 512(b)(13). For this reason, it is important to be mindful of the percentage ownership that is being acquired by the Charity and the potential for earned income being realized during the length of time which the Charity is likely to hold the controlling interest in the company.

WARD AND JUNE CLEAVER
(Wally and Theodore – a.k.a. "the Beav") FLIP-CRUT

Facts:

- Donors are husband and wife with two adult, disabled children who receive government benefits.
- Husband is in the early stages of Alzheimer's.
- Donors have a combined estate of approximately $950,000, including a 490 acre tract of land recently appraised at $550,000.
- Donors' attorney has drafted a trust agreement that would place the 490 acre property into a charitable remainder unitrust and would require the charity/trustee to assume guardianship, at Donors' deaths, of the disabled adult children for the duration of their lifetimes in conjunction with a "special needs" trust.
- The CRUT would pay income first to Husband and Wife, and then to the adult children thereafter for the duration of their lives.

- Husband signed a durable power of attorney, naming Wife as his agent, within the past three months.

Issues:

- Guardianship & Disability Planning
- Capacity of Donor
- Value of Gift in Relation to Estate
- Gift Tax

Guardianship & Disability Planning: Donors' attorney assumed that Charity, a children's home, would be willing and able to assume care for the disabled children as a part of managing assets for them through the trust arrangements. In addition to liability concerns, Charity is not organized to provide this type of service. Disability planning (including care of the person and management of the estate) is a specialized area of law that requires knowledgeable input from an experienced planner, especially when government benefits are involved. Care must be taken to assure that the entity named as guardian is qualified and capable to serve in that role. Further, the structuring of a special needs trust for asset management and disbursement to disabled family members must be properly done to provide the greatest financial benefit and to assure that the public benefits of the disabled children are not compromised.

In this case, questions arose as to the adult children's disability and impairment - they were living independently. At no point was it apparent that the adult children were aware of or involved in this planning.

Capacity of Donor: Under Texas law, an agent is allowed to make charitable gifts under a durable power of attorney so long as the power of attorney document specifically grants that authority to the agent. A charitable gifts provision is not included in Texas' statutory form and must be specifically added. A general gifts provision is included in the statutory form but must be specifically chosen and limits gifts to the annual exclusion amount to any one individual. In this context it might be advisable for the grant of power to include express authority to create the charitable remainder trust and allow estate planning. In this case, the power of attorney document did contain the necessary provision to allow Wife to make a charitable gift on behalf of Husband. However, Husband must have the requisite mental capacity to execute a durable power of attorney at the time he signs it. Because Husband signed the power of attorney after the Alzheimer's diagnosis, the capacity question is unavoidable. The attorney (who also prepared the power of attorney) reported that, on the day Husband signed the power of attorney, he was, "having a good day." If the trust is challenged, a court could find that Husband lacked capacity and determine that the charitable trust is null and void.

Value of Gift in Relation to Estate: The plan proposed by Donors' attorney would place almost 60% of the Donors' estates into an irrevocable charitable trust. Due to the lack of more specialized disability planning and the uncertainty of future needs for Husband (with Alzheimer's) and the disabled adult children, it is unwise to place such a significant percentage of the Donors' estates into an irrevocable charitable trust. This arrangement leaves the Donors vulnerable to significant financial difficulties if additional principal is needed in future years. The children's home which benefits from the trust could be accused of overreaching, exercising undue influence, etc.

Gift Tax: Including the children as secondary income beneficiaries on a charitable remainder trust will result in gift tax consequences for the gift to children as well as the surviving spouse. A unitrust which names only a husband and wife as income beneficiaries allows the surviving spouse's income interest to qualify for the gift tax marital deduction. IRC § 2523(g)(1). However, by including the children as income beneficiaries, both the surviving spouse's interest and the children's interests constitute taxable gifts. IRC § 2511(a). Although the gift to the surviving spouse is a gift of a present interest for which the annual exclusion is usually available, such a gift does not qualify for the marital deduction in this situation. IRC § 2503(b).

For this reason, it may be worthwhile to consider including provisions in the Donors' wills which would allow them to terminate the children's and each other's survivorship interests in the trust, causing recognition of these taxable gifts to be deferred until such time as they become a present interest. In other words, the gift tax would not be realized on the surviving spouse's interest until the date of the first spouse's death, and the gift tax attributed to the children's interests in the trust would not be realized until the date of the surviving spouse's death. Rev. Rul. 79-243; Treas. Reg. §§ 1.664-3(a)(4) and 25.2511-2(c).

JED CLAMPETT FLIP-CRUT

Facts:

- Donor owns 47% of the outstanding shares of a closely-held S corporation, and he serves as chairman of the company's board of directors.
- Donor's ownership interest is valued at approximately $4 million.
- The board of directors is currently considering an offer to sell the company to a larger competitor.
- The shareholders of the company will meet in three weeks. A vote to approve the sale is expected to occur at that meeting.
- Donor's shares are highly appreciated, and he wants very much to avoid the capital gains tax that would result from the sale.
- Donor wishes to place the shares into a charitable remainder unitrust to benefit several charitable organizations.

Issues:

- Anticipatory Assignment of Income
- S Corporation Stock
- Qualified Appraisal

Anticipatory Assignment of Income: Because the sale of the company is drawing near, care must be taken to assure that an anticipatory assignment of income does not occur upon the transfer of the Donor's shares to the trust. The oft quoted statement regarding the assignment of income doctrine made by Justice Oliver Wendell Holmes states that an "arrangement by which the fruits are attributed to a different tree from that which they grew" is not recognized for income tax purposes. *Lucas v. Earl, Guy* (1930, S. Ct.) 8 AFTR 10287, 281 US 11, 74 (Ed 73), 2 USTC. When an anticipatory assignment of income does occur, the gain from the sale of the stock is taxable to the donor on the theory that the asset transferred to the charitable trust by the donor was, in practical effect, a right to receive cash rather than an asset that might or might not be converted to cash at some time in the future.

However, a "mere anticipation or expectation of the receipt of income" is insufficient to conclude that a fixed right to income exists. *S.C. Johnson & Son, Inc. v. Commissioner*, 63 T.C. 778, 787-88 (1975). In the situation where the transfer to the charitable trust is made before the shareholder vote to liquidate, the gain will be taxed to the charitable trust, not the donor, but because the remainder trust is a tax exempt entity, no recognition of gain will occur. *Stern v. Commissioner*, 15 T.C. 521 (1950). So, time is of the essence.

Whether the assignment of income doctrine and/or the step transaction doctrine apply are fact sensitive questions. Although control over the disposition of the transferred property is significant to the assignment of income analysis, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. *Ferguson v. Commissioner* (174 F3d 997 (9th Cir. 1999)).

Note: In all relevant cases on this point, the Service did not assert that the donation itself was defective or that the charitable deduction should be disallowed. The issue was always the exclusion of capital gain arising from the donated asset.

S Corporation Stock: A transfer of shares of S corporation stock to a charitable remainder trust will cause the corporation to immediately lose the S election for all shares, not just for those shares actually contributed to the trust. IRC § 1361(e)(1)(B)(iii). In most cases, the resulting negative tax consequence for all other shareholders will preclude a donor from gifting S stock into a CRUT. However, because all of the company shares in this situation will soon be sold, this otherwise undesirable result may be of little consequence to the other shareholders.

It is also important for the Donor to be aware that, if the S corporation has operated as a C corporation at any time during the previous ten years, the corporation could have some retained earnings that would be taxed as ordinary income upon the conversion of the corporation by the loss of the S election.

Qualified Appraisal: In order to receive an income tax charitable deduction for his gift, the Donor must comply with certain appraisal requirements. The fair market value of the stock on the date of the gift must be determined by a "qualified appraisal" that follows all the rules set by the IRS. Treas. Reg. § 1.170A-13(c). Specifically, the qualified appraisal rules apply to gifts of property (other than money and publicly traded securities) if the value claimed or reported for the property is in excess of $5,000. Treas. Reg. § 1.170A-13(c)(1)(i).

Note: A special rule exists for gifts of nonpublicly traded stock. If the claimed value of the stock exceeds $5,000 but is less than $10,000, the Donors will not be required to obtain a qualified appraisal. Rather, they will be required to attach a partially completed appraisal summary form (Form 8283, Section B, Parts I and II) to the tax return on which the deduction is first claimed. Treas. Reg. § 1.170A-13(c)(2)(ii).

The sole purpose of the appraisal is to allow the Donor to obtain his income tax charitable deduction, and the IRS will not allow a deduction without this appraisal. Accordingly, the Donor and his advisors bear the responsibility to obtain the qualified appraisal and to ensure that the appraisal is properly completed in a timely fashion and meets all of the requirements for qualification. While the donee Charity may be able to provide helpful information about the qualified appraisal rules, the final determination of the sufficiency of any appraisal rests with the Donor and the Donor's advisors.

The appraisal must be prepared no sooner than 60 days prior to the date of gift; however, the Donor is not required to have the appraisal in hand until he actually files the income tax return on which he will first claim the deduction. Treas. Reg. § 1.170A-13(c)(3)(iv)(B).

ARCHIE and EDITH BUNKER (and GLORIA) CRUT

Facts:

- Donors want to establish a trust to benefit Daughter for life and Charity thereafter.
- Donors want the trust to take effect at their deaths, but they have just completed a comprehensive estate plan that they do not want to revise.
- Donors are emphatic that the Trustee not receive any type of fee or reimbursement for the expenses of administering the trust.
- Donors' attorney creates a "revocable deferred charitable remainder unitrust" (a fictitious animal that cannot be found anywhere in the Internal Revenue Code), naming Donor as initial trustee and Trustee as successor trustee.
- Donor suggests that Charity cover the fee obligation for the trust or that fees be waived entirely by the Trustee.

- Trustee is also a tax-exempt organization, established to manage endowment assets and administer life-income charitable gift arrangements on behalf of other related tax-exempt organizations.

Issues:

- Misapplication of Charitable Funds
- Private Inurement
- Excess Benefit
- Bargain Sale
- Self-Dealing
- Qualification

Misapplication of Charitable Funds: Could Trustee waive the administrative fee for this trust altogether? Some nonprofit organizations that serve as trustees do this, but it is ill advised. There are unavoidable costs in the administration of any trust, and the Trustee's overhead should be properly allocated to all accounts under management. Should Trustee waive the administrative fee for this trust, this could be construed as a misapplication of funds on Trustee's part in that the portion of Trustee's operating expense which should have been properly allocated to this trust would have to be borne by other accounts administered by Trustee.

Private Inurement: To be qualified as an entity described in section 501(c)(3) of the Internal Revenue Code, a charitable organization must be organized and operated so that, "no part of [its] … net earnings … inures to the benefit of any private shareholder or individual." IRC § 501(c)(3). Because a qualified charitable organization must be organized and operated exclusively for exempt purposes, the doctrine of private inurement prohibits a charitable organization from using its income or assets in any manner that would, directly or indirectly, unduly benefit a "private shareholder or individual" for nonexempt purposes.

For purposes of applying the doctrine, the words "private shareholder or individual" in § 501 refer to "persons having a personal and private interest in the activities of the organization." Treas. Reg. § 1.501(a)-1(c). The essence of the doctrine is to ensure that a charitable organization is serving a public interest rather than private interests, such as those of designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Notwithstanding the excise taxes that could be imposed on disqualified persons under IRC § 4958 for having received an excess benefit (discussed below), the only direct sanction for violation of the private inurement doctrine is loss of the charitable organization's tax-exempt status. In this case, should the charitable remainder beneficiary pay the trust's administrative fee, rather than having the fees taken directly from the assets of the trust, this would be an expenditure of charitable resources outside the scope of the Charity's exempt purpose that would also unduly benefit the Donors' daughter through larger payments derived from a larger trust asset value. While this offense alone is unlikely to produce the harsh consequence of loss of the

Charity's exempt status, charitable organizations should avoid transactions that result in private inurement.

Private Benefit Distinguished: It may be helpful to distinguish the private benefit doctrine from the private inurement doctrine. As with a violation of the private inurement doctrine, an organization that violates the private benefit doctrine will also fail to qualify as an exempt organization, or maintain exempt status, under IRC § 501(c)(3). The concept of private benefit is a derivative of the "operational test" contained in IRC § 501(c)(3), derived from the language in that section which states that a charitable organization must be "organized and operated exclusively for religious, charitable, scientific …literary, or educational purposes." Nonetheless, the private benefit doctrine is often overlooked when the operational test is actually applied or is ignored because the private inurement doctrine is applied. Hopkins, The Law of Tax-Exempt Organizations § 13.7 (John Wiley & Sons 1992).

In a 1989 opinion, the U.S. Tax Court clarified that the prohibition against private benefit is not limited to situations where the benefits are conveyed solely to an organization's "insiders", as is the case with the private inurement doctrine. *American Campaign Academy v. Commissioner,* 92 T.C. 1053 (1989). Accordingly, the private benefit doctrine can be applied more broadly than the private inurement doctrine. Nonetheless, in the case at hand, the Donors' relationship to the organization would cause them and their daughter to be categorized as "insiders" and would cause the transaction to be construed under the private inurement doctrine rather than the private benefit doctrine.

Excess Benefit: While a violation of the private inurement doctrine could result in the loss of an organization's exempt status in extreme cases, no additional deterrent was in place prior to 1996 to discourage insiders from engaging in such inappropriate transactions. As a result, Congress determined in 1996 that sanctions should also be imposed on an insider who receives benefits from an organization which is exempt from tax under IRC § 501(c)(3) beyond the value of any services or other consideration the insider provides to the organization. HR Rep. No. 506, 104th Cong., 2d Sess. 55 (1996). Specifically, excise taxes are imposed on any "disqualified person" who engages in such an excess benefit transaction with a tax-exempt organization. IRC § 4958.

The term "disqualified person" includes persons who are in a position to substantially influence a charitable organization's affairs, a family member of such a person, and entities in which those persons own a 35 percent or greater interest. IRC § 4958(f)(1); Treas. Reg. § 53.4958-3(a)(1). Disqualified persons are defined to include members of the organization's governing board, those who implement the decisions of the governing board or supervise the operation of the organization, and those who manage the finances of the organization. Treas. Reg. § 53.4958-3(c). Further, other individuals not mentioned in the foregoing list may also be found to be a disqualified person if the relevant facts and circumstances tend to show that the person has substantial influence over the affairs of the organization. Treas. Reg. §§ 53.4958-3(e)(1), 53.4958-3(e)(2). One fact that tends to show that a person may have substantial influence is the making of substantial contributions to the organization. Treas. Reg. §§ 53.4958-3(e)(2)(i), 53.4958-3(e)(2)(ii).

As mentioned above, an excess benefit transaction is a transaction wherein a charitable organization provides an economic benefit to or for the use of a disqualified person, directly or indirectly, the value of which exceeds the value of any services or other consideration received in exchange. IRC § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(a)(1). The amount by which the value of an economic benefit to a disqualified person exceeds the consideration received by the organization is an excess benefit. IRC § 4958(c)(1)(B); Treas. Reg. § 53.4958-1(b).

Further, a tax-exempt organization may provide an economic benefit indirectly through an entity it controls or through an intermediary. Treas. Reg. § 53.4958-4(a)(2)(i). A tax-exempt organization provides an economic benefit to a disqualified person through an intermediary if (1) the organization provides an economic benefit to an intermediary (including individuals, taxable entities, and tax-exempt organizations) that participates in a transaction with a disqualified person, and (2) there is evidence of an oral or written agreement or understanding between the organization and the intermediary that the intermediary will provide an economic benefit to or for the use of the disqualified person. Treas. Reg. § 53.4958-4(a)(2)(iii).

In this case, the IRS could employ the facts and circumstances test to argue that the Donors have substantial influence over the charity by virtue of their significant contributions to the organization, and as a result, would be classified as disqualified persons. This argument could be strengthened further if the Donors included a provision in the trust agreement which would allow them to change the charitable beneficiary under the trust going forward, thereby increasing the influence (or leverage) the Donors would have over the Charity. The Donors' daughter would also be considered a disqualified person by virtue of her relation to her parents.

Should the Charity agree to pay the Trustee's annual administrative fees for administering the trust, the trust would serve as an intermediary between the Charity and the Daughter. The Trustee's administrative fee is customarily assessed against the assets of the trust each year, thereby reducing the corpus of the trust by the amount of the fee. Should the Charity pay the Trustee's administrative fee on its own, the corpus of the trust would not be reduced. For a unitrust, this slightly larger corpus amount would result in a higher annual revaluation of the trust, and the Daughter, as a disqualified person, would be receiving an excess benefit in the form of a higher annual payout amount. Consequently, the Daughter would be subject to an excise tax equal to 25 percent of the excess benefit amount each year and additional excise taxes up to 200 percent of the excess benefit amount for any infraction which is not corrected within the taxable period. IRC § 4958(a)(1); IRC § 4958(b).

Bargain Sale: A bargain sale is a transfer of property which is in part a sale or exchange of the property and in part a charitable contribution of the property.

Treas. Reg. § 1.170A-4(c)(2)(ii). If the Charity were to pay the administrative fees for the trust, the arrangement would have to be considered a bargain sale whereby the Donors' deduction would properly be offset by the present value of the fees expected to be paid by the Charity for the duration of the trust term.

Self-Dealing: IRC § 4941 imposes sanctions on self dealing transactions that occur between certain "disqualified persons" described in the code section and private foundations. A charitable remainder trust which complies with IRC § 664 and for which a deduction is allowed under IRC § 170 is a "split interest trust" described in IRC § 4947(a)(2), thereby making it also subject to the self dealing sanctions imposed by IRC § 4941. As a result, using the income or assets of a charitable remainder trust (beyond the allowed payout amount) for the benefit of a disqualified person constitutes a prohibited act of self-dealing. IRC § 4941(d)(1)(E).

The term "disqualified person" includes substantial contributors, greater than 20 percent shareholders of substantial contributors, private foundation managers (or an individual having power or responsibility concerning the administration or operation of a charitable trust), family members of the foregoing, and partnerships or estates or trusts in which the foregoing have greater than 35 percent ownership interests. IRC § 4946(a)(1); IRC § 4946(b).

The transactions prohibited as self dealing include (1) sales, exchanges and leases of property; (2) loans; (3) supplying of goods, services or facilities; (4) excessive compensation or expense reimbursements to employees and other persons performing services for the foundation (or the charitable trust); (5) transfers of income or assets to a disqualified person or for their use by or for the benefit of a disqualified person. IRC § 4941(d)(1).

A disqualified person who participates in a self dealing transaction is subject to a tax of 5 percent of the amount involved in the transaction, while a foundation manager (or trust administrator) who knowingly participates in a self dealing transaction will be subject to a tax of 2½ percent of the amount involved. IRC § 4941(a). If the parties involved in the transaction fail to correct or rescind the self dealing transaction in a timely manner, an additional tax equal to 200 percent of the amount involved may be assessed against the disqualified person, while an additional tax equal to 50 percent of the amount involved may be assessed against the foundation manager (or trust administrator). IRC § 4941(b).

As a family member of the grantor of a charitable trust, the Donors' daughter meets the definition of a "disqualified person" in this situation. IRC § 4946(a)(1). Likewise, certain employees of the Trustee who have authority or responsibility concerning the administration or operation of the trust may also meet the definition of a disqualified person.

It cannot be overlooked that there is an inherent cost to the Trustee to administer the charitable trust. If the Trustee were to waive its usual administrative fee (which is assessed annually against the corpus of the unitrust), the corpus of the unitrust would not be reduced by the amount of the annual administrative fee, allowing the Daughter to realize the benefit of higher unitrust payments than she would have otherwise. As a result, the Service could view this arrangement as a self dealing transaction and impose sanctions as described above.

Qualification: Based upon the foregoing issues, it is also possible that the IRS could question the qualification of the trust as a charitable remainder trust under IRC § 664. The applicable income tax regulations state that "in order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust." Treas. Reg. § 1.664-1(a)(4). Should the IRS conclude that the above-described abuses rise to a level whereby the trust is no longer functioning exclusively as a charitable remainder trust, then the Service could disqualify the trust for failing to meet the definition of a charitable remainder trust under IRC § 664. If this occurs, then none of the trust's income would qualify as exempt under IRC § 664.

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