New Act & Ruling: What Are the Fundraising Repercussions?

Here's what nonprofits need to know.

BY J. MICHAEL PUSEY

Many nonprofits are unaware of a recent law and IRS ruling, both of which could have far–reaching impacts. Here's how these new policies will affect you—and how you can bolster your fundraising in response.

New Act: Two Consequences for Nonprofits

On August 20, 1996, President Clinton signed the Small Business Job Protection Act of 1996 (the 1996 Act). The Act has two major ramifications for nonprofits:

1. **More People May Decide to Donate Appreciated, Listed Securities to Private Foundations or CRTS that Benefit Them.**

The Act reinstates a crucial exception to charitable–deduction law, known as the "qualified appreciated securities exception." This exception applies to donors who contribute listed securities to private foundations. It increases these donors' income–tax deductions by letting them deduct such gifts at fair market value. The Act reactivates this exception (which expired in 1994) for contributions made after June 30, 1996, and before June 1, 1997 (an 11–month window). Caveat: An executive holding restricted securities in a listed company may not qualify.

The Act has special implications for charitable remainder trusts (CRTs), which are important planned giving tools. With a CRT, donors establish a trust which gives them a regular income. When they die or the trust is terminated, the remainder goes to their designated charity. If this designated charity is a private foundation, the charitable deduction for a transfer of appreciated, listed securities to a CRT will increase under the new Act.

Keep in mind, however, that with a CRT, the charitable deduction is *not* the full value at the time the trust is funded. Rather, it's the discounted value based on the projected value at the trust's *termination.*

Some nonprofits are wondering whether the new law will persuade people to donate appreciated, listed securities to private foundations rather than publicly supported charities, or to designate a private foundation rather than a publicly supported charity in a CRT. That may happen if donors are leaning toward foundations to begin with. But the law is unlikely to induce donors to abandon their favorite charities. Professionals raising money for charity can point out the many tax and other factors that still make it worthwhile to choose charities over foundations.

2. **More Business Owners May Decide to Donate S Stock.**

Small (and sometimes large) business owners make an "S election" which avoids tax at the corporate level. The income flows straight to the individual's Form 1040. If the corporation is not an S corporation, there is a corporate tax, then another tax to the individual when dividends are paid.

Till now, the law hasn't let charities be shareholders of S corporations. The 1996 Act changes that, allowing 501(c)(3) organizations to be among the S corporation shareholders. Thus, the Act may encourage gifts of S stock by small business owners.

J. Michael Pusey is a V.P. with Covenant Group, Inc., a financial services firm with an emphasis on charitable planning and charitable trust administration. Mr. Pusey is author of Charitable Remainder Trusts for the Citizen and Foreign Investor, *a 1,000+ page treatise published by Covenant Group, Inc., 3741 Merced Avenue, Suite A, Riverside, California 90004. Mr. Pusey is co–author of* Tax Planning Techniques for Individuals, AICPA Tax Study No. 2, Revised Edition. *He is author of numerous tax articles.*

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Note, however, that the flow–through income from the S corporation, as well as gains on selling the stock while the S election is in effect, will be subject to unrelated business income tax (UBIT). So weigh the cost before accepting gifts of S stock.

While the new bill allows charities to own S stock without terminating the S election, this new rule doesn't apply to charitable remainder trusts. As in the past, the transfer of S corporation stock to a CRT will terminate the S election.

Note also that there will be a slight delay before this change takes effect. The new law allowing S corporations to have charities as shareholders becomes effective in 1998.

New IRS Ruling: CRTs as Family Affairs

Many charities seem unaware of a recent IRS ruling (PLR 9547004) which says that a CRT isn't supposed to be a "family affair." This ruling is based on a case in which grandparents and grandchildren wanted to donate to the same CRT by contributing cash, cash equivalents, and appreciated securities. The grandchildren were successor beneficiaries, receiving monies from the trust only after the grandparents. The trust was an 11% net income unitrust with makeup provisions (NIMCRUT).

The IRS's response to a CRT with eight grantors was that the trust was an "association" having predominantly corporate characteristics and thus was tax-

Glossary

Actuarial calculation: Calculation of future costs, based on life expectancy and assumed rate of investment returns.

Appreciated securities: Securities with greater market value than when first acquired.

Capital gain (or loss): Gain or loss from the sale of capital assets, such as stocks.

* **Charitable remainder annuity trust (CRAT):** An irrevocable trust established by a donor to provide payments of a certain sum to one or more noncharitable beneficiaries for life (or for no more than 20 years), after which the remainder goes to charity.

* **Charitable remainder trust (CRT):** An irrevocable trust created to provide payments for a person's life (or for a term of no more than 20 years). When the trust ends, the irrevocable remainder goes to charity.

* **Charitable remainder unitrust (CRUT):** An irrevocable trust set up by a donor to pay a set percentage of the trust's assets to charity, at least once a year, for the donor's life (or for a term of no more than 20 years). When the person dies or the trust is terminated, the remainder goes to charity.

Fair market value: The price that would be paid for an item in the normal course of business.

Grantor: Person who forms and funds a trust.

** **NIMCRUT:** Abbreviation for "net income charitable remainder unitrust with makeup provisions." Example: a charitable remainder unitrust that calls for payment to the recipient of 11% of the annual value of the trust's assets but not more than the net income of the trust, with one exception: In any year in which net income exceeds 11% of the trust's value for that year, the trustee must distribute the excess to make up deficits from years in which net income was less than 11% of the value.

Planned giving: Arrangement in which a donor sets aside money or property for a charity's future use.

PLR (private letter ruling): The IRS's decision on a tax issue, in response to a request for a ruling on a particular situation. While PLRs do not create law or binding precedents, the IRS tends to follow them in future rulings.

Private foundation: There are four types of private foundations: non–operating, operating, pass–through, and company–sponsored. For details, see Knowlton in "Selected References."

** **S corporation:** Corporation that is not taxable. Income is taxed to the corporation's shareholders. Corporations and their shareholders decide whether to be S or C corporations, depending on which will offer the best tax advantages. Until this new law was passed, if nonprofits received or held stock in S corporations, those corporations lost their S status and became regular C corporations. Thus, donors did not often contribute the stock of S corporations. The new Act may well change that.

Securities: Documents, especially stock certificates, showing ownership in a financial enterprise.

* **Trust:** Arrangement in which a grantor conveys property to a trustee to hold and manage for the benefit of one or more beneficiaries. Trusts can be revocable or irrevocable, charitable or noncharitable.

Unrelated Business Income Tax (UBIT): A tax nonprofit organizations pay to the IRS even if they are tax–exempt. The IRS requires this tax on income from business that isn't directly related to the nonprofit's mission. UBIT can be especially harsh when received by a CRT because it causes *all* the trust's income—not just unrelated business income—to be taxed. Thus, it's very important that CRTs avoid unrelated business income.

*Adapted from *The NSFRE Fund–Raising Dictionary*, John Wiley & Sons, 605 Third Avenue, New York, N.Y. 10158–0012.
**Adapted from *Practical Guide to Planned Giving*, Taft Group, 12300 Twinbrook Parkway, Suite 520, Rockville, Maryland 20852.

able as a corporation. The IRS concluded that the combination of "associates" (family members) and "business purpose" (despite the absence of a business) caused the otherwise qualified CRT to fail on the grounds that it was not even a trust for tax purposes.

The ruling is unofficial, since it only applies to the taxpayers addressed in the ruling, but it clearly signals a shift in IRS policy. Discussions with the IRS National Office indicate that the IRS will no longer tolerate more than one grantor for a CRT. (The grantor is the one who forms and funds the trust.) For example, the IRS says that if a brother and sister contribute co–owned property to a CRT, the trust will not be a qualified charitable remainder trust, whether the trust is a charitable remainder unitrust (CRUT) or charitable remainder annuity trust (CRAT). Reportedly, the only exception to this new one–grantor–only policy is that a husband and wife can still contribute to the same CRT. This ruling is a major change from previous IRS policy.

The IRS seems unjustified in concluding that joint funding causes a CRT to become a corporation. For a detailed discussion of why a CRT does not look like an corporation even when there is some commingling of assets by multiple grantors, see Pusey in "Selected References."

From a policy standpoint, the IRS position is unwarranted for two reasons:

The new IRS ruling is troubling in many other ways.

(1) It discourages charitable donations. (2) It makes it necessary to create multiple trusts to achieve the same charitable goals. Thus, it increases costs and reduces the ultimate proceeds to charity via CRTs.

One type of charitable remainder trust, the charitable remainder unitrust (CRUT), may receive additional contributions after the initial funding if the trust instrument provides for such contributions. If the IRS forbids multiple grantors, what about additional "contributors" in the case of a CRUT? The IRS addressed this situation in another ruling (PLR 8919016). This ruling concerns a case in which the grantor and her sisters funded a 10% NIMCRUT with their interests as co–tenants of real estate. The two sisters were technically not grantors, but simultaneously made "additional contributions" upon the initial funding of the unitrust. Since the IRS no longer allows multiple grantors, it would almost certainly nix this arrangement too.

There are any number of circumstances in which non–grantor individuals or trusts may make additional contributions to a CRUT. We can't be certain when these might cause an IRS challenge as in PLR 9547004.

The new IRS ruling is troubling in many other ways. Planned giving professionals will want to review existing trusts and estate plans for potential problems under the new IRS policy. For example, donors sometimes fund a CRUT and a noncharitable trust, planning to flow additional assets into the CRUT from the noncharitable trust when the latter terminates. It isn't clear that this will be permissible under the new IRS one–grantor–only policy. It isn't even entirely clear that a parent will be able to contribute to a CRUT for the kids if the parents divorce. We can only hope that the IRS will not push its new policy to this extreme.

Planners may want to consider multiple CRTs, which may add a degree of certainty and avoid the need for asking the IRS to rule on their particular situation. On the other hand, multiple trusts will mean higher administrative and investment costs, and these are recurring expenses.

Weigh the cost before accepting gifts of S stock.

The new IRS policy adds a layer of complexity and uncertainty to charitable planning and will trigger numerous, unnecessary ruling requests. It's imperative for all nonprofit leaders to be aware of the new IRS policy and take appropriate steps to help donors.

A Little Known Plus of CRTs: What If Investments Decline?

One way to help donors in the wake of the new act and IRS policy is to reinforce the benefits of planned giving. Some of these benefits are obvious, while you may need to do a little digging for others.

Assume, for example, that prospective donors are considering what to do with their appreciated stock. Should they sell the stock, realize the once–in–a–lifetime gain, and pay a large capital gains tax? Or should they contribute the stock to a CRT? Charitable remainder trusts are well known for their ability to avoid capital gains tax in this situation. Because there is normally no capital gains tax within the trust, the amount paid from the trust to the noncharitable beneficiary may be enhanced. Even if the prospective donor is not overly charitable, this is a major benefit to weigh against the cost of the gift. A CRT involves a deferred transfer to charity, but it does cost the donor something in that the trust eventually transfers its assets to charity rather than the family unit.

You can point out other planned–giving advantages to prospective donors. By setting up a CRT, for instance, they may save estate taxes. Also, if they name a beneficiary in a relatively low tax bracket, they will pay less income taxes.

There's a less well–known benefit that you should also explain to the prospective donor. This is the CRT's ability to avoid the capital loss limitation provision—a harsh, unfair rule that limits investment–loss deductions. The rule is familiar to tax professionals but not so well–known to others. It works like this: If investors realize a large capital gain, they pay capital gains tax in the year of sale. If they invest the proceeds and suffer a subsequent loss, they can't carry that loss back to offset the previous gain. They can deduct the loss only up to $3,000 a year. They can carry the loss forward, but it doesn't pass on to their heirs.

The CRT can avoid this problem. If investment values go down after forming the trust, future losses will just reduce the net cumulative gain within the trust. The trust's net cumulative capital gain is one factor that can affect whether the beneficiary's income is characterized as capital gain. But the trust's capital loss doesn't run afoul of the capital loss limitation rule. ■

This ruling is a major change from previous IRS policy.

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