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Planned Giving News

FIRST QUARTER 2007

CHARITABLE REMAINDER TRUSTS AND UNRELATED BUSINESS TAXABLE INCOME

by Maye Albanez

A provision in the Tax Relief and Healthcare Act of 2006, which was signed by the President on December 20, 2006, changed the tax treatment of charitable remainder trusts (CRTs) that have unrelated business taxable income (UBTI). Prior to this law being passed, a CRT would lose its tax-exempt status for any taxable year in which it had any UBTI, even one dollar of it. Under the new law, one dollar of UBTI results in one dollar of excise tax, but the tax-exempt status of the trust is otherwise left intact.

The introduction to IRS Publication 598 offers some background on the subject of unrelated business income and reads as follows:

> *"…if an exempt organization regularly carries on a trade or business that is not substantially related to its exempt purpose, except that it provides funds to carry out that purpose, the organization is subject to tax on its income from that unrelated trade or business.…"*

More important than understanding what unrelated business income is, is to understand what unrelated business *taxable* income (UBTI) is. The Internal Revenue defines it as follows:

> *"… the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed … which are directly connected with the carrying on of such trade or business.…"*

The simplest way to understand the implications of the new law may be by using an example, in this case, the gift of real estate property to a university:

> *Joe gives real estate property worth $1,000,000 to University ABC in January of a given year. Joe's cost basis on the property is $500,000. By donating it and not selling it in the open market, Joe avoids the capital gains tax on the unrealized gain of $500,000. Joe and ABC set up a 5% CRT, which receives the gift; ABC is named trustee (and remainderman), and Joe becomes the life income beneficiary.*
>
> *ABC sells the property in June of the same year. With the proceeds, ABC buys a diversified portfolio. Besides buying stocks and bonds, ABC purchases a small interest in a partnership that runs a grocery store in the same town.*
>
> *By the end of the year, the CRT has received income totaling $52,000 which includes interest, dividends, rent and $2,000 in UBTI from the grocery store partnership. In addition, it has paid beneficiary distributions to Joe totaling $50,000 for the same year.*

THE TAX PAID BY THE CRT RESULTS IN TWO VERY DIFFERENT OUTCOMES IF UBTI OCCURS IN 2006, RATHER THAN IN 2007.

In 2006, the CRT loses its tax-exempt status because the partnership investment generates $2,000 of UBTI. As a result, the trust pays not only ordinary income taxes on the small

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FINANCIAL ADVISORS—FRIEND OR FOE OF THE CHARITY'S PLANNED GIVING PROFESSIONALS-PART 2

by Jim Fox

In our last newsletter we discussed the growing influence financial advisors are having in the gifting decision process of wealthy philanthropists. In some older, established wealth management firms this is not a new phenomenon. It has been a factor for generations. What is new is the proliferation of entry level advisors and the recent explosion of financial planners. Many of these new practitioners are still learning the trade while working with wealthy families who expect them to be expert in many or all areas of financial decision making, including charitable giving strategies. The nuances of

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amount of net income for the year, but also 15% capital gains taxes (assuming these are long-term gains) on the $500,000 gain on the sale of the property. Total tax for 2006 comes to a little more than $75,000.

In 2007, on the other hand, the CRT preserves its tax-exempt status even though it generates $2,000 of UBTI from the partnership investment. Tax due for 2006 is $2,000, or 100% excise tax on UBTI for the year.

Although the change in the law allows for a more fair and reasonable treatment of taxes due to UBTI in CRTs, in our minds it still makes little sense to expose the trust to UBTI, as the entire amount is turned over to the tax authorities in the form of excise tax. Taken to the extreme, even under the current law, the effect of UBTI in a CRT can be catastrophic. In conclusion, UBTI should be treated with the greatest respect when it comes to CRTs. In a perfect world, it should be avoided altogether. But when forced to deal with it, a tax professional or attorney well versed on CRTs and UBTI should have the final word and always be consulted ahead of time. §

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planned giving are technically challenging, sometimes overwhelming, to this segment of investment advisors.

What does this suggest for the planned giving professional who is prospecting donors directly? There are essentially two issues at work here: the increasing influence of financial advisors on donor philanthropic decisions and the level of planned giving expertise these same advisors bring to the decision table. At the very least, the established advisor-donor relationship introduces a third participating influence into the equation. In some cases, the influence is strong enough to be categorized as a gate-keeper who evaluates proposals for giving on behalf of the donor. It's possible that your effort to solicit the donor may be intercepted without an opportunity for you to interact with the prospective donor directly.

How can the development community capitalize on this important advisor-donor relationship? Advisors operate on a fee basis and do not sell products or participate financially in their recommendations. They prosper if their clients appreciate their contribution and continue the consulting relationship. There is an inherent protective attitude toward the client. Anyone, including a development professional, who seeks a cooperative arrangement with an advisor, must offer something that helps the advisor be more effective in meeting their client's objectives.

The most obvious assistance a development professional could provide a financial advisor is education in the merits of and ways to affect a planned gift. One-on-one discussions with locally-based advisors offer an opportunity to help the advisor identify opportunities for planned gifting more effectively. In many cases, the advisor will be too overwhelmed with pressing investment activities to commit the time to become personally versed in the nuances of all possible vehicles. Some advisors may prefer to be a charitable giving generalist and have a resource like you, the development professional, available to assist in client meetings to describe these vehicles in greater detail. If this is the case, you gain great leverage with the advisor and their firm. While you will not be encouraged to promote your charity, it will be identified to the prospective donor as part of your introduction and the establishment of your professional credibility. Any prospective donor will certainly show interest in your institution's mission if they have crossed the line concerning the merits of a deferred gift structure.

Another possible way to work with an advisor is joining with him or her in seminar-type meetings. Some advisors will periodically arrange group meetings for their clients and present new ideas for them to contemplate. A credible guest speaker is always a welcome possibility.

Most successful advisors do not respond well to suggestions that a reciprocal arrangement has merit. It is true some large financial institutions have been known to hint at the possibility of charitable gifts in exchange for new business. The vast majority of registered advisors would consider this approach both unprofessional and a crude effort to counter competitive weakness. Advisors appreciate helpful advice and professional efforts. It is possible an advisor's client will have a real interest in the work of your institution. Therein lies the payoff for this development effort. Occasionally, an advisor's client will want to establish a gift solely for tax and estate reasons. Your advisor ally could legitimately suggest your institution as the logical recipient.

Our suggestion to planned giving professionals is to work with local financial advisors to assist them and their clients in several areas. Advisors must determine the most effective vehicle to achieve their client's financial, tax, and philanthropic objectives. You, as a planned giving professional, can position yourself as the advisor's expert ally. You will not only enhance your professional stature in his or her eye, but you may also stimulate them to expose you and your institution to their most wealthy clients. In addition to identifying critical, and deserving, characteristics of the organization you represent, this is an opportunity to help advisors and donors approach your institution – who should they contact and what information should they seek? This cooperative relationship creates the best opportunity to flush out donors who will find an interest in your organization. §

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