dollar amounts to each donee. Mr. and Mrs. McCord wanted to give $6,910,932.52 worth of their partnership interests to their sons, $134,000 worth of their partnership interests to the symphony, and the balance of the value of their partnership interests, if any, to a community fund. The same appraiser used at the time of formation was also used to determine the value of each 1% partnership interest as of the date of the gift. The donees used the appraisal to convert the dollar value of each gift into percentage interests and entered into a confirmation agreement. Mr. and Mrs. McCord were not involved in the confirmation agreement, each donee had independent counsel, each donee could review the appraisal, and each charity could hire its own appraiser. Three months after signing the confirmation agreement and after obtaining an updated appraisal, the partnership redeemed the charities' interests. Mr. and Mrs. McCord timely filed gift tax returns and the Service issued deficiency notices valuing the interests at nearly double that of the McCord's appraiser. The Tax Court found against the McCords after applying its own methodology for valuing the donated interests based upon the confirmation agreement – an argument never raised by the Service. The Appellate Court held that, by applying the confirmation agreement, the Tax Court "violated the firmly-established maxim that a gift is valued as of the date that it is complete." The Court also held that the discounts taken by the McCords for § 2035 estate tax liability were proper. Further, the Court held that the McCords were entitled to a charitable deduction for the gifts made to the charities.

Trust With Charitable and Non-Charitable Beneficiaries Does Not Qualify for Charitable Deduction, Edmond C. Galloway v. United States, No. 05-50 (May 9, 2006).

The U.S. District Court for the Western District of Pennsylvania considered cross-motions for summary judgment on an estate's right to take a charitable deduction. James D. Galloway established a revocable trust in 1991. The trust provided, among other things, that the residue of the estate would be distributed in equal shares to two natural persons and two charities – half in 2006 and the balance in 2016. The successor trustee filed the estate tax return on which it claimed a charitable deduction in an amount equal to the portion of the trust that would ultimately be distributed to the charitable beneficiaries. The IRS denied the deduction because the trust created a split interest that did not comply with IRC §2055(e)(2). The trustee paid the disputed amount and sued for a refund. Section 2055(e)(2) states that no deduction is allowed for split interest that is a remainder interest unless such interest is in a CRAT, CRUT or pooled income fund. The estate argued that the trust does not split interests in the same property and that the statute is ambiguous. The Court held that trust was a split interest trust that did not fit within any of the enumerated exceptions and that the statute was not ambiguous. Accordingly, the Court denied the estate's motion for summary judgment, and granted the government's motion.

Drafting Problems and Reform Delay Result in Loss of Charitable Deduction in Estate, Estate of Tamulis v. Commissioner, T. C. Memo 2006-183 (August 29, 2006)

In this tax court case, the decedent, a Roman Catholic priest, died with a will that transferred his estate net of taxes and expenses to his living trust which became irrevocable at his death. After payment of specific bequests, the trustee was directed to make distributions in the form of pecuniary amounts, discretionary payments, and periodic payments under certain conditions to or for the benefit of various relatives and heirs. At the end of the trust term, all remaining assets were to be distributed to the Roman Catholic Diocese. On the estate tax return filed in November 2001, a charitable deduction of $1,495,526 was claimed for the assets passing to the Diocese. Two years later, the IRS denied the deduction and filed a notice of deficiency because the trust's payment structure did not meet the requirements of a charitable remainder trust under IRC §2055. The Tax Court held: the trust did not meet the requirements for a charitable deduction at the decedent's death; the payment structure to non-charitable beneficiaries could only be amended to comply with IRC §2055 through court action; and the requisite judicial action was not initiated within the required 90 days from the date the estate tax return was due.

Foundation Denied Tax Exempt Status Based on Operational Practices, New Dynamics Foundation v. United States, No. 99-197T (April 24, 2006)

This case illustrates the types of abuses that have prompted Congress to call for nonprofit reforms. New Dynamics Foundation, a California non-profit corporation, was denied tax-exempt status and in this action sought a declaratory judgment under Sections 501(a) and 501(c)(3) of the IRC. An organization is entitled to an exemption when it is organized and operated exclusively for one or more exempt purposes and no part of its net earnings benefit a private person. The court held that the Foundation failed to operate exclusively for exempt purposes. Instead, the Foundation engaged in a pattern of conduct which showed a willful neglect and participation in a scheme designed to produce inappropriate tax benefits. The Foundation, formerly a sub-fund of the National Heritage Foundation (a public charity), was comprised primarily of donor advised funds and foundations. Its promotional materials stated that donors who gave money to the Foundation would be able to "warehouse wealth," eliminate estate taxes, avoid capital gains, and provide tax free retirement benefits. The trustees allowed distributions to cover donors' personal travel expenses, to compensate family members for volunteer work, to pay school tuition and expenses, and to purchase non-income producing assets. One particularly egregious example of an inappropriate expenditure involved a retired doctor's purchase of a $147,000, 43-foot motor home from which he occasionally provided free medical services for Indians and similar populations as he traveled. During its first year, less than 5% of the donations received actually went to public charities. The Court held in favor of the IRS and dismissed the Foundation's complaint.

c) Third, the taxpayer must complete the transfer of his full interest in the property within ten years. The charitable deductions for the partial interest transfers are recaptured if the donor has not transferred his full interest or charity has not taken "substantial physical possession" of the item at the end of the ten years or death. (Regulations are expected to provide guidance for interim situations.)

Avoiding the Top Five Problem Areas in Charitable Gift Planning

Charitable gift planning offers advisors and donors an array of options and tax benefits which can be used to create the "perfect" charitable gift. Unfortunately, many gifts fail to yield the expected donor benefits or the anticipated charitable impact, often because the planner has strayed into one of five common gift planning problem areas. On the theory it is always easier to learn from some one else's mistakes, the most frequently encountered planning obstacles are listed below.

1. ***The donor's personal and charitable goals are not clearly articulated before the gift is planned.*** Just as a financial plan is created to support the client's needs and objectives, a charitable gift must be structured to fit the donor's personal and philanthropic objectives. Begin the gift planning process by helping the donor express his expectations. How important is the charitable deduction and is this the primary motivation for the gift? Does the donor need to create a gift that generates income for himself or a family member? Is the donor interested in creating a gift that facilitates family involvement in distribution of charitable funds? What is the anticipated charitable impact of the gift? Can the donor fund the gift now or should the gift be structured in a testamentary arrangement? Without the answers to these questions, the planner can not effectively recommend the appropriate funding asset, gift form, gift structure or gift timing. In one memorable client meeting, I observed a donor's attorney and counsel struggle to convince a donor to accept the published charitable gift annuity rates offered by the charity. She insisted on a rate 1 ½ percent higher. When her advisors finally backed up to determine her objectives, they learned she wanted the higher rate to fund gifts to charity each year! In other words, she didn't need a charitable gift annuity – she wanted a donor advised fund. Once they learned her objectives, the gift planning went smoothly.

2. ***The gift is more complex than required to achieve its intended purpose.*** Overly-complex gifts may range from the creation of a private foundation or a supporting organization instead of a more appropriate donor advised fund or outright gift, or the creation of a charitable remainder annuity trust when a charitable gift annuity would suffice. Sometimes the gift is made unnecessarily complex when conditions are imposed making the gift expensive to administer and inflexible in long-term application. For example, a $5,000 endowed gift to a church restricts the income to the purchase of specific books, or a small scholarship requires a complicated application process. Always contact the charity when adding gift conditions to ensure the gift will have the intended beneficial impact.

3. ***The gift is "sold" as a way to avoid taxes and leverage the charitable deduction for personal benefit with little focus on philanthropic intent.*** While it is always important to put the client's goals first in the planning transaction – after all, the planner represents the client, not the charity – some gift proposals go too far. This happens when gifts are sold as products, or sold as cutting edge "secrets" that use the charitable deduction to "create" wealth or unusually generous personal benefit. For example, a donor advised fund is "sold" as a way to avoid taxes and pay personal expenses on a tax-discounted basis. (See New Dynamics Foundation v. United States in this newsletter.) Or, a charitable family limited partnership is "sold" as a way to discount transfers to family members by leveraging the charitable deduction. Or a charitable reverse split-dollar arrangement is marketed as an opportunity to create wealth on the back of the charitable deduction based on loopholes in the law. These gift plans invariably disappoint when the IRS shuts them down or the results do achieve the touted benefits.

4. ***The wrong asset is used to fund the gift.*** Donors are quick to write a check when there may be tax-advantaged or non-income producing assets that would create a more beneficial personal result. Although the asset must always be appropriate for the gift form and the anticipated charitable use, the simplest example of an advantageous gift asset is the use of long-term appreciated marketable securities rather than cash. The benefits are two-fold: the donor receives a charitable deduction and avoids tax on the asset's capital gains. At death, the example may be allocating a charitable bequest from IRD assets such as an IRA rather than making the bequest from less taxed residual assets. In some cases, the best gift asset is closely-held securities, real estate (such as an unused vacation home), or an art collection. These assets may have outlived their use and have high expense levels associated with ownership.

5. ***The donor is left with ongoing gift administration responsibilities – and little ability or guidance to fulfill those duties.*** Tax law is not intuitive and a donor may go astray without ongoing supervision. This can occur when a donor serves as trustee of his charitable remainder trust, especially a trust with unusual distribution provisions or non-marketable assets. It can be equally challenging when donor as trustee of a new private foundation is responsible for avoiding the self-dealing rules, making the required annual distributions, making grants to "appropriate" charitable beneficiaries, and investing the assets in compliance with the IRS regulations. Donors in these circumstances need clear instructions, regular review, and support.

Avoiding these traps will increase client satisfaction and improve both the quality and quantity of planned charitable gifts in your community.

2. ***Start IRA transfers early and document the transaction.*** The law is new and each custodian may approach the process differently. The best advice for clients is to start early, anticipate problems, and keep good documentation.

   - Call the fund custodian to request the letter of instruction they require for such transfers. If they do not have a letter of instruction specific to IRA charitable transfers, you may be required to draft such a letter to accompany the standard letter used by that custodian. The key is to make it clear the donor's intent is to make a transfer in accordance with the PPA 2006. Please contact a member of the Gift Planning Team if you would like a sample instruction letter for your clients.
   - Transfers take time, and year end is busy. Actively manage the process to ensure the transfer takes place by or before year end so the client does not lose the opportunity to make a transfer for 2006.
   - The donor appears to be responsible for determining if the transfer is a "qualified charitable distribution" under the PPA 2006. Advise clients that distributions to donor advised funds (as now defined), supporting organizations, private foundations, any transaction with an economic benefit, or transfers that would not otherwise be gross income are not qualified charitable distributions.
   - Anticipate confusion in tax reporting. The Service has stated that the distribution should be reported as regular distribution on the Form1099-R. There will be a procedure on the 2006 Form 1040 so that taxpayers may exclude direct distributions to charities from their IRA.
   - Make sure the donor receives substantiation from the charity acknowledging the gift. Since a check from the IRA custodian may not reveal the donor's name or contact information, the donor will need to alert the charity the gift is on its way and follow up to ensure receipt.

3. ***Substantiation rules have been expanded.*** Gifts of cash or cash equivalents less than $250 must now be supported with written documentation in the form of a written substantiation from the charity or a "bank record". This may create problems for Salvation Army kettle donations, church gifts, and similar undocumented or unsubstantiated cash gifts. United Way of America has written for direction on the impact of the rule on its fall workplace campaigns.

4. ***Counsel and monitor donor advised fund distributions.*** Help donors determine whether their advised fund fits the statutory definition, and if so, to monitor distributions. Donor advised funds are defined as funds that:

   a) Are separately identified by reference to the donor (such as donor name in the fund name or tracking contributions from specific donors in the charity's records);

   b) Are owned and controlled by a sponsoring organization; and

   c) Over which the donor (or his appointee) has a reasonable expectation to advise on investments or distributions.

   Donor advised funds *do not* include funds restricting distributions to a single qualified charity or government entity or those that make scholarship-type distributions to individuals for travel, study, or similar purposes if the fund has an approved process (similar to private foundations) ensuring objectivity or a selection committee that is not controlled by the donor. Funds may be exempted by the Secretary of the Treasury if the fund is advised by a group not controlled by the donor or benefits a single charitable purpose.

   Key rules to watch:

   - No grants to individuals, for non-charitable purposes, to Type III supporting organizations (unless functionally integrated), to type I or II supporting organizations if controlled by the donor or an advisor, or to private non-operating foundations.
   - Grants loans, compensation and similar payments to donors, advisors and related parities are considered excess benefit transactions (as of August 18, 2006); penalties can be levied on the person recommending the grant as well as the person who received the benefit for the value of an economic benefit to a donor, advisor, or related parties.
   - Penalties apply if compensation for investment advice for the fund is deemed excessive.

5. ***Stop, look, and analyze before making partial interest gifts of tangible personal property.*** New rules applicable to partial interests of tangible personal property – primarily affecting art and other high-value property – are now very unattractive for donors.

   a) First, the deduction is available only when the tangible personal property is owned by the donor and the charity. (The Treasury may issue regulations allowing taxpayer/donors who share interests in the property to make lock-step gifts.)

   b) Second, the charitable deduction for subsequent partial interest gifts are limited to the lower of market value at gift or market value at the date of the first partial interest transfer. If the property appreciates over the multi-year period, the donor's deduction is limited to the market value in year one and the balance of the market value at transfer is a taxable gift subject to estate and gift taxation.

All bequests abate ratably and decedent's intent may not be derived from extrinsic evidence where assets of a trust are insufficient to pay all bequests, Handelsman v. Handelsman, No. 2-05-0790 (July 7, 2006)

The Illinois Appellate Court considered an appeal of a grant of summary judgment by the adult children of the decedent holding that (1) the decedent intended, through extrinsic evidence, that the trustee first pay the surviving spouse's bequest before paying the bequests to the children; and (2) the trustee use trust funds to pay off the mortgage on the home before transferring it to the surviving spouse. The decedent executed a will and a trust providing for his spouse and adult children from his previous marriage. The trust stated that the trustee shall distribute to the surviving spouse the home free and clear of any and all mortgages as long as it was as asset of the trust. The surviving children would each receive $1 million less any payments received from an insurance trust. The real estate, which was held by a land trust, was never transferred into the trust. Previous correspondence between the decedent and his lawyer and memoranda to the file showed that the decedent intended to provide for his surviving spouse before providing for his children. No express language in the trust, however, set forth such a preferential treatment. Decedent died and there were insufficient assets in the trust to pay off all the bequests. The court rejected the surviving spouse's argument that listing specific bequests separately means that they abate in the same order listed and held that the bequests abate ratably. The court also held that reformation was not appropriate. The trust was not ambiguous and errors occurred because the decedent's lawyers made errors in legal and factual assumptions when drafting the trust.

Suggested Wording for Making a Bequest

If your or your client would like to make a bequest to a program or hospital of Advocate Health Care, please make the bequest to Advocate Charitable Foundation for the benefit of the hospital or program. For example:

When making a specific bequest: "I give Advocate Charitable Foundation, Park Ridge, Illinois, 60068, the sum of $_________ [to be used by the (insert name of hospital or program) for its general purposes or according to a letter of intent previously agreed to by the Foundation and me].

When making a residual bequest: "I give Advocate Charitable Foundation, Park Ridge, Illinois, 60068, _______ percent of the residue of my estate [to be used by the (insert name of hospital or program) for its general purposes or according to a letter of intent previously agreed to by the Foundation and me].

For further information, please contact the Office of Gift Planning at 847.384.3418. Our staff would be pleased to assist you.

Estate Assignment of IRA to the Charitable Residual Beneficiary Avoids Tax on IRD, Letter Ruling 200617020

The executor sought a ruling that an assignment of the decedent's IRA to the charitable residuary beneficiary was not a transfer under IRC §691(a)(2). The decedent designated his estate as the beneficiary of his IRA. The Will named a charity as the estate's residuary beneficiary and gave the executor the power "[t]o make payment, division or distribution required by this Will, either in cash or in kind, or partly in each, in such manner and such proportions as they shall deem appropriate, either with or without regard to the income tax consequences of any such sale to my estate or the income tax consequences of any such distribution to the beneficiary or beneficiaries receiving such property." The executor proposed to assign the IRA to the charitable beneficiary in partial satisfaction of the charity's share. If permitted, the executor would not have to include in the estate's gross income the income in respect of a decedent ("IRD") in the IRA. The IRS ruled the assignment would not be considered a transfer under IRC §691 and that only the charity would include the IRD in the IRA in its gross income.

Assignment of Tax-Deferred Annuity to Charitable Residuary Beneficiaries Similarly Deemed "Not a Transfer," Letter Ruling 200618023

In facts similar to the previous Letter Ruling, the executor sought a ruling that an assignment of the decedent's non-qualified deferred annuity contract to the charitable residuary beneficiaries was not a transfer under IRC §691(a)(2). The decedent owned a deferred annuity contract that had not reached its annuity starting date, had been purchased after October 21, 1979, and had no named beneficiary. Under state law, the estate was the beneficiary of the annuity. Although the decedent's will did not specifically authorize the executor to make in-kind or non-pro rata distributions, state law granted the executor such power. The IRS ruled the assignment of the deferred annuity would not be deemed a transfer under IRC §691 and the charities, rather than the estate, would include the IRD in the IRA in their gross income.

New Legislation

Pension Protection Act of 2006, Pub. L. 109-280, 120 Stat. 780 (August 17, 2006)
The Eight Provisions Every Gift Planner Must Read

The Pension Protection Act of 2006 (hereinafter PPA 2006) contained some of the most dramatic revisions to the tax laws relating to nonprofits and charitable gifts since 1969. The new rules are complex and there are no regulations. Every gift planner should read the following eight sections, summarized below, which impact gift planning. Section references are to the corresponding sections of the bill. The bill's text is available at http://thomas.loc.gov by searching for "HR 4".

Incentives *(all expiring December 31, 2007):*

1. § 1201 - *Lifetime distributions from IRAs to public charities.* The PPA 2006 allows individuals age 70 ½ or older to direct distributions of up to $100,000 in 2006 and 2007 from a traditional or Roth IRA to most public charities (donor advised funds and supporting organizations are excluded). The transfers must be made directly from the IRA to the designated charity, without any economic benefit in return, from dollars that would have otherwise been taxable as gross income to the donor. Transfers to charity under the PPA 2006 are counted as required minimum distribution amounts, do not flow through the donor's adjusted gross income, and may not be deducted as a charitable contribution.

2. §1206 - *Expanded deduction limits for real property gifts for conservation purposes.* Deduction limits for gifts for conservation purposes have been expanded to 50% of AGI and the carryover period extended to 15 years for unused gift portions. Even more favorable results can be achieved for donors who are qualified farmers or ranchers.

3. §1203 - *Favorable basis rules for S Corporation gifts to charity.* S Corporation gifts of appreciated property to charity now reduce the S Corporation shareholders' basis by a pro rata share of the gift's basis instead of the previous reduction by a pro rata share of the gift's market value.

Reforms *(all permanent):*

4. §1218 - *Tangible personal property gifts are limited by new restrictions.* Several provisions of the Act restrict gifts of tangible personal property. In particular, §1218 burdens partial interest gifts with complicated new rules that could mean lower deductions for multi-year gifts, possible recapture of the charitable deduction, and taxable transfers on gift and estate tax returns. (Effective after date of enactment.) See "Charitable Planning in Practice" for more detail.

5. §1219 - *Appraisal penalties are increased*: The penalty threshold for gift valuations has narrowed so that appraisers face penalties if the appraisal is 150 percent or greater of "true value". The appraiser will not be able to assert a "reasonable cause" exception if the appraisal is 200% or greater of "true value". Most sections are effective after date of enactment, with one section effective July 25, 2006.

6. §§1231, 1232 - *Donor advised funds are now defined, distributions restricted, and new penalties imposed.* Donor advised funds are now defined in the tax code (new IRC §4966). Distributions are prohibited to individuals and for non-charitable purposes and exercise of expenditure responsibility required for others. Penalties are imposed for grants that provide "more than incidental benefit" to the donor, donor advisor, or related person, and certain transactions – such as grants, loans, compensation, and expense reimbursements – between the donor or donor advisors and the fund are taxed as excess benefit transactions. §1231 is applicable for tax years after date of enactment, §1232 is applicable to donor advised funds on date of enactment.

7. §§1242, 1243 - *Supporting organizations are now subject to new excise taxes and restrictions.* Type I, II, and III SOs are subject to the excise taxes for grants, loans, compensation, expense reimbursements paid to disqualified persons; Type IIIs are subject to excise tax on excess business holdings, cannot sponsor donor advised funds (unless the SO is functionally integrated), and will be subject to a required payout to be set by the IRS. §1242 is applicable to transactions after July 25, 2006; §1243 is applicable to tax years after date of enactment.

8. §1217 - *Gifts of less than $250 require documentation.* Gifts of cash or cash equivalents of less than $250 must now be supported by a letter from the charity stating the donor's name, the charity's name, the date, and the amount of the contribution or a "bank record". This provision is effective for tax years beginning after date of enactment.

Items of Interest to Planners

Charities Received $260.28 Billion in Contributions in 2005, a 6.1% Increase Over Prior Year, Giving USA 2006, Giving USA Foundation, http://www.aafrc.org/press_releases/trustreleases/0606_PR.pdf

Giving USA 2006, an annual report of the Giving USA Foundation (formerly, the AAFRC Trust for Philanthropy) reported contributions to charities reached $260.28 billion in 2005, a figure equal to 2.1% of the U.S. Gross Domestic Product. The 2005 figures represented a 6.1% increase over 2004. The publication, which is researched and written by the Center of Philanthropy at Indiana University, reported individuals contributed the bulk of the donations. As shown in Table 1, individuals made outright gifts of $199.07 billion (76.5% of all gifts) and bequests of $17.44 billion (6.7% of all gifts, totaling 83.2 percent of all contributions in 2005). Giving per household was estimated to be 2.2 percent of average household disposable income.

TABLE 1: *Sources of Charitable Gifts, AAFRC Foundation - Giving USA 2006*

Source	Dollars (in Billions)	% of Total Giving	Increase Over 2003
Individuals	$199.07	76.5%	6.4%
Bequests	$17.44	6.7%	-5.5%
Foundations	$30	11.5%	5.6%
Corporations	$13.77	5.3%	22.5%
Total Giving	$260.28	100%	6.1%

Religious organizations once again attracted the largest percentage of contributions, receiving $93.18 billion, or 35.8% of all gifts. Educational entities received $38.56 (14.8%) and human services received $25.36 (9.7%). Giving USA 2006 noted the significant role of disaster relief in giving in 2005 which accounted for $7.37 billion (2.8%) of total giving for the year. Charitable sector recipients are detailed in Table 2.

TABLE 2: *Recipients of charitable donations - Giving USA 2006*

Charitable Sector	Dollars (in Billions)	% of Total Contributions
Religion	$93.18	35.8%
Education	$38.56	14.8%
Human services	$25.36	9.7%
Health	$22.54	8.7%
Gifts to foundations	$21.70	8.3%
Unallocated giving	$16.15	6.2%
Public-society benefit	$14.03	5.4%
Arts, culture, and humanities	$13.51	5.2%
Environment and animals	$8.86	3.4%
International affairs	$6.39	2.5%

Charitable Planning in Practice

The Five Greatest Challenges in Gift Planning After the Pension Protection Act of 2006

Every advisor with an estate or charitable planning practice will have clients affected by the Pension Protection Act of 2006. Advisors will play a key role in ensuring compliance and best client results, especially as donors make year-end giving decisions without experience, regulations, or guidelines to interpret the new law. Consider this advice in five areas of potential concern.

1. ***Do the math on charitable IRA transfers.*** The Investment Company Institute estimates Americans held an estimated $3.3 trillion in traditional IRAs and $145 billion in Roth IRAs in 2005. Donors have expressed considerable interest in using the new Charitable IRA Rollover option to pay annual gifts, endowment gifts, and campaign pledges. If your client is age 70 ½ and considering a qualified charitable distribution from an IRA, do the math to ensure that transfer will achieve a better result than an outright or split interest gift coupled with a taxable distribution from the IRA. Results depend on the individual's tax profile (including bracket and itemization), available assets (and those assets' character and appreciation), and state law.