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Planning to Maximize the Tax Benefits of Charitable Gifts from an Estate

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Mistakes or oversights in estate planning for charitable gifts can result in unfortunate and unnecessary tax liabilities. This article provides an overview of issues to consider when advising clients with an estate plan that includes charitable gifts. Effective planning requires careful drafting, attention to the technicalities of the estate tax charitable deduction, consideration of tax allocation, and income tax planning. In addition, tax efficient planning involves identifying assets in your client's estate that will be "income in respect of a decedent" and planning to fund charitable gifts with those assets.

1. Understand, Verify, and Draft Your Client's Intent.

"*I leave the residue of my estate to The University of Southern California known as The U.C.L.A.*"[1] This bequest and the ensuing probate litigation are reminders that clear drafting matters when charitable gifts are part of your client's estate plan. Understanding your client is the first step in drafting clear and accurate bequests. If your client intends to make charitable gifts from her estate, it is important that you take the time to ensure that you know what your client wants to do and whom she wants to support.

Once your client has identified her charitable goals, you can do some simple research on the charity to ensure that (1) you have the name of the organization correct, and (2) the organization is in fact a charity recognized as a tax-exempt organization by the IRS. If your client is naming a larger charity as a beneficiary, the organization will likely have a website with a page on "planned giving" or "estate planning." Typically, this page includes sample bequest language that includes identifying information such as the organization's legal name, address, and taxpayer identification number. If the organization does not have an established website, there are free resources such as GuideStar and Charity Navigator[2] that provide searchable databases of tax-exempt entities. In addition, you can quickly verify the tax-exempt status of most domestic organizations using the IRS "Select Check" website.[3] This searchable database confirms that an entity is classified as tax exempt by the IRS and provides some basic information, including whether the entity is a public charity or private foundation.

1 *Estate of Black*, 211 Cal App 2d 75, 27 Cal Rptr 418 (1962) (the trial court thought this was a clear enough gift to UCLA, but the University of Southern California appealed, and the appellate court agreed that it was an ambiguous bequest).
2 These resources are accessible at guidestar.org and charitynavigator.org.
3 The Select Check database is at: https://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check. The Select Check database is an electronic form of Publication 78. Churches may not be listed in the Select Check database because churches are not required to apply for tax-exempt status.

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Finally, draft a provision that identifies the intended beneficiary and a statement of your client's intent that the gift be used exclusively for charitable purposes. The statement of intent can be broad, such as, "To the Oregon Humane Society, to be used for its general charitable purposes," or specific to the client's intent, such as "To the Oregon Humane Society, to be used for its charitable purposes in caring for dogs and puppies." If your client is making a gift to a national charity, include an instruction as to whether the gift is intended for the national organization or for a local chapter. A clear statement of charitable intent can only help your client's estate if questions arise about the purpose of the gift.

2. Ensure That the Gift Qualifies for the Estate Tax Charitable Deduction.

The estate tax charitable deduction is at Section 2055 of the Internal Revenue Code ("IRC"). The federal rules apply for purposes of the Oregon estate tax because Oregon law does not have any state-specific rules that are applicable to the estate tax charitable deduction.[4]

The estate tax charitable deduction is available for all "bequests, legacies, devises, or transfers" to corporations organized "exclusively for religious, charitable, scientific, literary, or educational purposes" and other organizations described in Section 2055(a) (referred to in this article as "qualified charitable organizations"). The table that is included at the end of this article compares some features of the estate tax charitable deduction to the income tax charitable deduction.

The estate tax charitable deduction is fairly generous. However, there are technicalities in Section 2055 that we need to be mindful of in order to plan effectively. The following discussion highlights certain features of the estate tax charitable deduction that may be overlooked from time to time.

(a) The gift must be from the decedent's estate to a qualified charitable organization.

In order to qualify for the estate tax charitable deduction, the gift must pass to charity from the decedent's estate. This can be a bequest in a Will, a gift in a revocable trust, a beneficiary designation that names a charity, or the exercise of a general power of appointment in favor of a qualified charitable organization. The property must pass directly to the qualified charitable organization. A gift to an individual affiliated with a charitable organization is not deductible.[5] A gift to individuals with precatory language expressing a hope that the property will be given to charity is not deductible.[6]

A gift to charity may be deductible even if the decedent does not identify specific organizations in his estate plan. For example, a gift to charitable organizations selected by the estate's fiduciary or another individual may be deductible so long as the fiduciary is restricted to selecting beneficiaries that are qualified charitable organizations.[7] Of course, your client may want to describe a smaller class of potential beneficiaries that are engaged in a cause that is important to her. This is permissible so long as any potential beneficiary is a qualified charitable organization.

(b) The gift must be presently ascertainable as of the date of death.

Importantly, the estate tax charitable deduction is allowed only if the gift to charity is "presently ascertainable" as of the decedent's date of death.[8] Mistakes often occur in the planning phase that violates this "presently ascertainable" standard. The following examples are helpful in understanding what the presently ascertainable standard is, as well as illustrating how well-intentioned estate plans run afoul of this rule.

The first example involves a situation where a qualified charitable beneficiary was named as the beneficiary of the residue of an estate, but the amount of pre-residuary gifts could not be ascertained as of the decedent's date of death. The decedent's revocable trust directed his fiduciary to "compensate persons who contributed to my well-being" by giving each such person an amount equal to 1% of the value of his estate. The fiduciary had unlimited discretion to select those persons who contributed to the decedent's well-being. The balance of the estate was to pass to a university, which was a qualified charitable organization.[9]

The problem in this case was that there was no way to determine on the decedent's date of death the amount that would pass to charity from his estate. The fiduciary could identify 50 individuals who contributed to the decedent's well-being and, as a result, distribute 50% of the estate to non-charitable beneficiaries. Or perhaps – as actually happened – the fiduciary could identify only two such individuals, and 98% of the estate would pass to the university. The issue was that "these elements are uncertain and cannot be measured with any precision, and therefore they make the amount going to charity unascertainable at the time of death. The fact that only two persons received payments * * * is of no moment, because this could not be determined at the time of death so as to

4 For purposes of computing the Oregon estate tax, a decedent's taxable estate is the federal taxable estate subject to certain adjustments. ORS 118.010(3).
5 TAM 9531003 (May 1, 1995).
6 *Delaney v. Gardner*, 204 F2d 855 (1st Cir 1953).
7 Rev Rul 69-285, 1969-1 CB 222.
8 Treas Reg § 20.2055-2(a).
9 *Estate of Marine v. Commissioner*, 990 F2d 136 (4th Cir 1993).

affect ascertainability."[10] The result was that the charitable deduction was not allowed because the amount passing to charity could not be determined as of the date of death. This was the result even though most of the estate actually passed to a qualified charitable organization pursuant to the terms of the decedent's revocable trust.

A second example highlights the recurring problem under Section 2055 where the estate plan raises the question of whether the "decedent directed the transfer to a qualifying organization or whether the estate fiduciary made the transfer in the exercise of his discretion."[11] Typically, this happens when the fiduciary has some discretion over the distribution of the estate and the beneficiaries are not restricted to qualified charitable organizations. In this case, the decedent's revocable trust directed that "[u]pon the death of the Grantor * * * the Grantor's home shall, insofar as possible, be set aside by the Trustees as a historical site. The designation of this site and management shall be in the discretion of the Trustees."[12] The trust agreement did not include any further restrictions on the gift or a statement of charitable intent. The Tax Court found that the trustees could preserve the home as a historic site without transferring it to charity. Therefore, because the trustees could have carried out the client's intent without transferring the home to a qualified charitable organization, the charitable deduction was not allowed. This was the result even though the home was actually transferred to a qualified charitable organization.

(c) Split interest gifts are not deductible – unless the gift is of a type that is specifically allowed.

A "split interest gift" is a gift that results in separate interests in the same property passing to both a charity and a non-charity. The general rule is that split interest gifts do not qualify for the estate tax charitable deduction.[13] However, there are several important exceptions to this rule that may be useful planning options.[14] Split interest gifts to charity that may qualify for the estate tax charitable deduction include: an outright gift of an undivided portion of the property, an annuity or unitrust interest in a trust that meets the requirements of a charitable lead trust,[15] a remainder interest in a personal residence, a remainder interest in trust that meets the requirements of a charitable remainder trust,[16] and conservation easements.[17]

Practitioners are often surprised to discover (or be reminded) that a gift of a copyrighted work may create a split interest gift. This is particularly relevant when your client is an author, artist, or other creative type. For federal tax purposes, a work of art and a copyright are treated as two interests in the same property. For example, if an artist leaves her own works to the Portland Art Museum and the residue of her estate to her children, the paintings will pass to the museum but the copyrights pass to the children. This is a split interest gift and the estate tax charitable deduction for the gift of the works to the museum may not be allowed. In order for a gift of a copyrighted work to qualify for the estate tax charitable deduction, your client must either: (a) specifically include the gift of the copyright with any copyrighted work, or (b) ensure the gift is a "qualified contribution of a work of art," that is, a gift of property that will be used by the charity in furtherance of its exempt purpose.[18]

(d) Qualified disclaimers in charitable planning.

Disclaimer planning can be effective for a client who wants some flexibility and control on the part of the estate beneficiaries. The estate tax charitable deduction is allowed if a qualified disclaimer[19] results in assets passing to charity in a manner that qualifies for the estate tax charitable deduction under Section 2055.[20]

An issue in planning with disclaimers is whether a disclaimer is reasonable in light of the client's plan. If the client intends for assets to pass to the sister, or if the sister disclaims, then to charity, a disclaimer plan may be appropriate. The fiduciary of the estate can work with the sister, and they can determine whether she wants to disclaim any portion of her gift and, if so, ensure that the disclaimer meets the requirements for a qualified disclaimer. However, if the client wants an estate plan that provides "a gift to all those persons who contributed to my well-being" with the balance passing to charity, it would be impossible for the fiduciary to obtain qualified disclaimers from such a large and undefined class.

In disclaimer planning, it is important to remember that if a non-spouse beneficiary disclaims, he cannot retain any interest in the disclaimed property. In *Christiansen v. Commissioner*, the charitable deduction was not allowed where the decedent's daughter disclaimed and, as a result, property passed to a charitable lead trust of which the

10 *Id.* at 139.

11 *Estate of Edna Pearce Lockett v. Commissioner*, 75 TCM (CCH) 1731 (1998).

12 *Id.*

13 Treas Reg § 20.2055-2(e)(1)(i).

14 Treas Reg § 20.2055-2(e)(2).

15 Charitable remainder trusts are described at Treas Reg § 20.2055-2(3)(vi), (vii) [no subsection (3)(vi), (vii)].

16 Charitable remainder trusts are described at IRC § 664.

17 *See* IRC §§ 2055(f), 170(h).

18 IRC § 2055(e)(4)(A); Treas Reg § 1.170A-4(b)(3)(i).

19 The requirements for a qualified disclaimer are that the disclaimer must: (1) be written, (2) be received within nine months of the taxable transfer, (3) be of property from which the disclaimant has not accepted a benefit, (4) pass without direction of the disclaimant to someone other than the disclaimant or the disclaimant's spouse (unless the disclaimant is the spouse of the donor or the decedent), and (5) be valid under state law. IRC § 2518(b).

20 IRC §§ 2055(a), 2518; Treas Reg § 20.2055-2(c)(1).

daughter was the remainder beneficiary. In that case, the court determined that the disclaimer was not a qualified disclaimer because the daughter had an interest in the trust remainder. Since the disclaimer was not a qualified disclaimer, the estate did not receive a charitable deduction for any portion of the assets passing to the charitable lead trust.[21]

3. Consider Tax Apportionment

If your client's estate will be subject to estate tax, it is important to consider the question of which beneficiaries will bear the burden of the tax. Tax apportionment analysis is particularly important if the estate beneficiaries include both charitable and non-charitable beneficiaries. This is because the manner of tax allocation can impact the size of the estate tax charitable deduction and, as a result, the amount of tax.

Estate assets that qualify for the estate tax charitable deduction under Section 2055 are fully deductible. Estate assets used to pay federal or state estate taxes are not deductible. If estate tax is charged to a charitable beneficiary, the charitable deduction is reduced by the amount that is used to pay the tax liability.[22] The reduction in the estate charitable tax deduction will increase the overall tax, likely increasing the tax charged to the charitable beneficiary, and so on. The impact can be quite significant.

Under Oregon law, estate tax is not apportioned to a gift that qualifies for the estate tax charitable deduction.[23] This means that, absent a contrary instruction in the decedent's Will or revocable trust, estate taxes will not be charged to a charitable gift that qualifies for the estate tax charitable deduction. This may or may not be consistent with your client's intent. Your client may prefer this approach because it reduces the overall tax. Alternatively, your client may prefer to treat all beneficiaries the same, even if it increases the tax cost. Either approach is valid. What matters is that you discuss tax apportionment with your client, document these discussions in your file, and ensure that the documents you draft are consistent with your client's intent.

4. The Income Tax Charitable Deduction for Estates

Most estates will be subject to income taxes even if they will not be subject to the estate tax because the estate is smaller than the applicable estate tax exclusion amount. In addition, estates are subject to the highest federal income tax rate of 39.6% when they have income of just $12,400 (for 2016). Estates are also subject to the federal 3.8% "net investment income tax" once income reaches that top tax bracket. The Oregon income tax on estates ranges from 5%-9.9%, with the maximum rate reached when the estate has $125,000 of income.[24] Therefore, it is worth spending some time thinking about the income tax charitable deduction for estates of all sizes. This is particularly relevant when the estate will have to recognize assets that are "income in respect of a decedent" or "IRD."

The income tax charitable deduction for estates and trusts is at IRC Section 642(c). The table that is included at the end of this article includes some features of the income tax charitable deduction for estates as compared to the estate tax charitable deduction and the individual income tax charitable deduction.

The income tax charitable deduction for estates is generous in that it is unlimited in amount. However, the technicalities of the deduction are significant. The following is a summary of important considerations and applicable rules for the income tax charitable deduction for estates under Section 642(c).

(a) An estate for income tax purposes is not the same as an estate for estate tax purposes.

The estate tax is determined based on all assets that decedent owned or otherwise had an interest in as of his date of death.[25] In comparison, the estate income tax applies only to income generated by assets held by the estate during a period of administration. Similarly, income generated by assets held in a trust that was revocable during the decedent's lifetime will be subject to tax for a period of administration after the trustor's death.[26] However, income on assets that pass directly to a beneficiary – such as by beneficiary designation – is not recognized by the estate for income tax purposes. For example, if dad leaves his IRA to his daughter, the value of the IRA is included in his estate for estate tax purposes, but any assets withdrawn from the IRA will be recognized as income by the daughter, not by the estate.

(b) The income must be paid or permanently set aside for a charitable purpose described in Section 170(c) pursuant to the governing instrument.

The deduction is available only for charitable gifts made pursuant to the decedent's estate plan. The governing instrument is the Will, trust agreement, beneficiary designation, or other relevant document in the decedent's estate. This governing instrument must direct that income

21 *Christiansen v. Commissioner*, 130 TC 1 (2008).
22 IRC § 2055(c).
23 ORS 116.343(2).
24 ORS 316.037, 316.282.
25 IRC § 2031.
26 The income tax charitable deduction is available for estates and trusts; however, the deduction for assets that are "permanently set aside" for charity is allowed for trusts in limited situations. IRC § 642(c)(2). An election may be made to tax a trust as an estate for income tax purposes after the decedent's death. IRC § 645.

be paid to charity or that it be permanently set aside[27] for a qualifying charitable purpose. In general, a qualifying charitable purpose is a charitable purpose described in IRC Section 170(c).

(c) The fiduciary must be able to trace the payment of the charitable gift from the estate's income.

The income tax charitable deduction for estates continues to be interpreted to include a tracing requirement.[28] That is, the fiduciary needs to be able to show that the funds constituting income to the estate were the same funds paid to charity. Therefore, the fiduciary should take care to source such payment from estate income (not principal) and document the funds used to pay charitable gifts.

(d) The deduction is available to deduct only items of gross income.

The charitable deduction is allowed for distributions of an estate's "gross income."[29] For purposes of this charitable deduction, gross income includes IRD and capital gains, but it does not include principal or tax-exempt interest.[30]

(e) The character of income distributed from an estate to a charity is determined under a proportionality rule, unless the payment is made under a provision in the governing instrument that has "economic effect independent of income tax consequences."

Any income distributed from an estate to charity is deemed to consist of "the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes."[31] If an estate has income from multiple sources, the proportionality rule is applied to determine what portion of the income paid to charity is from sources that constitute "gross income" (and is therefore deductible) and what portion of the income paid to charity is not gross income (and therefore not deductible).

A governing instrument may include a direction that is intended to override this proportionality rule with an instruction as to what source of income a fiduciary is to use to pay charitable gifts. However, such a direction is respected for purposes of the income tax charitable deduction for estates only if the direction has "economic effect independent of income tax consequences."[32]

Economic effect independent of income tax consequences means that the direction impacts the amount charity receives. For example, if the governing instrument directs that "charity is to receive all ordinary income received by my estate," there is economic effect because the amount charity receives will be determined by the amount and character of income. However, if the instrument says, "Pay charity $100,000, and my fiduciary is to pay this amount first from ordinary income," there is no economic effect independent of income tax consequences. The charity is going to receive $100,000 from the estate regardless of the estate's income.

This simplified example illustrates the proportionality rule: Assume the Will provides for a $100,000 gift to charity, and the Will includes a direction to pay charitable gifts from IRD. The estate has $100,000 of IRD and $25,000 of tax-exempt income. Following the direction in the document, the fiduciary pays $100,000 of IRD to charity. However, this direction does not have economic effect independent of tax consequences. Therefore, under the proportionality rule, the character of the income paid to charity is deemed to consist of $80,000 of IRD and $20,000 of tax-exempt income. Since the income tax charitable deduction is limited to items of gross income, and gross income does not include tax-exempt income, the charitable deduction is limited to $80,000. The estate will be taxed on $20,000 of IRD income.

5. Maximizing Tax Efficiency: Planning for IRD

Gifts to charity from a decedent's estate can be particularly effective if the gift is funded with assets that are "income in respect of a decedent" or "IRD."[33] IRD is not a simple concept, but it is generally described as income that would have been gross income if the decedent had lived to receive it. Many of our clients have valuable IRD assets, including tax-deferred retirement savings, such as a 401(k) plan or traditional IRA, savings bonds, and installment notes.

It is important to consider planning for IRD for both estate and income tax planning purposes. IRD assets do not receive a basis adjustment on the owner's death.[34] The recipient of any IRD asset will recognize the income associated with that asset on his or its own tax return. For example, if dad owns an IRA valued at $2 million as of his death, the IRA does not receive a basis adjustment to $2 million on dad's death. The beneficiary of the IRA – be it dad's estate, his daughter, or charity – will recognize ordinary income when assets are distributed from the IRA to the beneficiary.

An additional feature of IRD assets that is significant for tax planning purposes is that IRD may be recognized

27 The "permanent set aside" option is only available for estates and certain trusts. A revocable trust can elect to be taxed as an estate during the administration period under IRC Section 645.
28 *Van Buren v. Commissioner*, 89 TC 1101 (1987).
29 IRC § 642(c).
30 Treas Reg § 1.642(c)-3(a), (b).
31 Treas Reg § 1.642(c)-3(b)(2).
32 *Id.*
33 IRC § 691.
34 IRC § 1014(c).

on both the estate tax return and the estate's income tax return. If dad's IRA is worth $2 million at his death, that amount will be reported on the estate tax return for dad's estate. In addition, the beneficiary of the IRA will have to recognize the income from the IRA. This means that the $2 million is taxed twice, once for estate tax purposes and once for income tax purposes. If dad's estate is the beneficiary of the IRA, the estate will have to recognize IRD as the funds are withdrawn. This means that the estate will recognize a significant amount of income that is taxed at the highest rates described above.

The ideal plan is to avoid recognition of IRD by the client's estate for income tax purposes. If your client is making gifts to charity, funding these gifts with IRD assets can be particularly tax efficient. For example, if dad names charity as the beneficiary of his IRA: (1) the value of the IRA is reported on the estate return, (2) the estate receives a corresponding estate tax deduction, (3) the charity recognizes the income associated with the IRA, and (4) the estate does not recognize any income from the IRA. Income recognition is not significant to the charity, since it is exempt from income tax.

Achieving this result may require using beneficiary designations to effectuate your client's estate plan. Keep in mind that many plan administrators of IRAs or similar accounts will not accept a designation of a pecuniary bequest, so the client will need to designate a percentage of their IRA to go to charity. As your client's retirement account balance increases or decreases, or after the death of a spouse, the beneficiary designation will need to be reevaluated to ensure that it is consistent with the overall estate plan. However, if your client is making large charitable gifts, do not let this complexity deter you from having a conversation with your client about funding charitable gifts with an IRA. The tax savings can be substantial.

Your client may be concerned about a charitable gift that is a percentage of the value of his IRA because the amount going to charity may end up being less than he intends. One way to address this concern is to include a gift of a makeup amount in his will or trust agreement. This provision directs the fiduciary to pay the charity the difference between the client's target amount and the amount the charity receives from any IRA or similar asset.

If IRD assets will be part of your client's estate and pass subject to the terms of his Will or revocable trust, the goal is to plan so that the estate will receive a corresponding income tax deduction. A specific bequest of IRD assets should be effective to transfer those assets (and the associated income) to charity. For example, a client may direct that all her savings bonds be distributed to charity.

Finally, consider including language in all of your documents that preserve an opportunity for the fiduciary to claim an income tax charitable deduction during the estate administration. First, ensure that the fiduciary has the power to fund gifts on a non-pro-rata basis.[35] If the estate fiduciary discovers an IRA payable to an estate with a charitable beneficiary, such a provision permits the fiduciary to assign that IRA to charity in satisfaction of its gift. The IRS has allowed an income tax charitable deduction for the assignment of an IRA by an estate to charity where charity is the residuary beneficiary.[36] In addition, consider including language that directs the fiduciary to pay any charitable gifts with IRD assets. This provision will not have economic effect, and, as a result, the amount paid to charity probably will not be characterized as being fully funded with IRD and, in turn, won't be fully deductible. (See the example of application of the proportionality rule, above.) However, if the fiduciary does in fact pay the gift with IRD, this provision will provide an instruction in the governing instrument that supports an income tax charitable deduction for the portion of the amount paid to charity that that is characterized as gross income under the proportionality rule.[37]

Conclusion

When advising a client who intends to make charitable gifts from her estate, we need to take the same time and care that we take with any other client. We must understand our client's goals and assist her by researching the intended beneficiary and drafting in a manner that clearly identifies the intended recipient and states the client's charitable intent. In addition, we must remember that the estate tax charitable deduction is generous, but there are technicalities that need to be respected in order to ensure your client's estate will benefit from it. Finally, a careful review of your client's assets, and developing a plan that pays charitable gifts with IRD to the extent that it is reasonable, can result in significant income tax savings for the estate's non-charitable beneficiaries. If we take these steps, we can help our clients realize their charitable goals in a tax efficient manner.

Refer to table on next page.

35 ORS 130.725(22) permits a trustee to make payments "in proportionate or disproportionate shares."

36 *See, e.g.*, PLR 201444024 (Mar. 24, 2014) (allowed IRD to be recognized by charity); PLR 200221011 (Feb. 12, 2002) (allowed charitable deduction on the rationale that assets were permanently set aside for charity); PLR 200336020 (June 3, 2003) (same). The IRS has not ruled favorably when the fiduciary attempted to assign an IRA to charity to satisfy a pecuniary bequest. PLR 201438014 (May 5, 2014)

37 For a detailed discussion of this issue, see Christopher R. Hoyt, *Structuring a Charitable Bequest of IRD Assets, Trusts & Estates*, June 2015.

Table from **Planning to Maximize the Tax Benefits of Charitable Gifts from an Estate**

Estate Tax Charitable Deduction (IRC § 2055)	Individual Income Tax Charitable Deduction (IRC § 170)	Trust/Estate Income Tax Charitable Deduction (IRC § 642(c))
Amount of deduction limited only by the value of the estate.	Amount of deduction limited by the type of charity, the type gifted property, and the client's income.	Amount of deduction limited to amount paid to (or set aside for) charity from gross income.
No carryforward (one time return).	Unused deduction may carryforward for 5 years.	No carryforward.
Available only if paid from the estate to qualifying organizations and the amount can be ascertained on the date of death.	Available for any charitable contributions to qualifying organizations.	Available only for amounts paid to qualifying entities pursuant to the terms of the governing instrument.
Available for amounts paid to foreign charities. Treas Reg § 20.2055-1(a)(4).	Available only for amounts paid to domestic charitable organizations. IRC § 170(c)(2)(A).	Available for amounts paid to foreign charities. IRC § 642(c)(1).
Amounts paid are deducted on the estate tax return (one time return).	Amounts paid are deductible in the year paid.	Election may be made to treat amounts paid in one year as paid in the prior year. § 642(c)(1).

Five Things to Know about Mark Zuckerberg's Charitable Pledge

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Mark Zuckerberg, the founder of Facebook, has pledged to put 99% of his stock in Facebook toward "advancing human potential and promoting equality." The value of his stock currently stands at $45 billion.

Zuckerberg and his wife, Dr. Priscilla Chan, launched the Chan Zuckerberg Initiative ("CZI") in 2009 by forming a Facebook page for CZI. From the date that the page was launched until now, Zuckerberg and Chan have donated a considerable amount of stock and cash towards supporting charitable causes. In 2013, they donated 18 million shares of Facebook stock, then valued at $992 million, to the Silicon Valley Community Foundation. This made them the most generous donors in the United States in 2013, according to a ranking released by *The Chronicles of Philanthropy.*

However, no formal business entity was formed for CZI until November 2015, just prior to the announcement of the pledge of the gift of 99% of his stock. In contrast to Bill Gates, who established the Bill & Melinda Gates Foundation, a private foundation, Zuckerberg has established a limited liability company, Chan Zuckerberg Initiative, LLC, to accomplish his goal. Here are five key points to consider with regard to this structure.

1. **By using a limited liability company to carry out this charitable pledge, Zuckerberg is maintaining a much greater degree of privacy than if he had formed a private foundation.** The use of a limited liability company to carry out a charitable pledge has surprised a number of people. Zuckerberg has not made any assertions that the company will be a nonprofit or tax-exempt entity.

   By using a limited liability company that is owned by a married couple in a community property state such as California, a separate income tax return for the company is not necessary. Instead when the company donates money to a charity, the tax deduction should flow directly to the Chan Zuckerberg income tax return. An individual's personal income tax return is clearly private information.

   Contrast the Chan Zuckerberg Initiative, LLC (LLC) to the Bill & Melinda Gates Foundation (Foundation). The Foundation must file an annual tax return; this return is publicly available. As such, anyone can review this return and discover the salaries paid to key executives, contributions made to the Foundation, and grants made by the Foundation. None of this information will be available with regard to Chan Zuckerberg Initiative, LLC's operations unless the entity voluntarily chooses to make its private tax information public.

2. **Continued control of the stock is a priority for Zuckerberg.** In the Securities and Exchange filings disclosing the pledge, it was clear that Zuckerberg will retain his majority voting position in Facebook. Zuckerberg has taken several steps to maintain his control over the stock.

   Facebook stock is divided into Class A common stock and Class B common stock. The rights of the holders of Class A common stock and Class B common stock are identical, except for voting and conversion rights. Each share of Class A stock is entitled to one vote. Each share of Class B common stock is entitled to 10 votes. Only the Class A stock is publicly traded. Dual-class capital structures can serve to entrench certain shareholders and management, insulating them from possible takeovers or other external influence or action.

   In addition to owning a large percentage of the Class B stock, Zuckerberg entered into voting agreements with other Class B shareholders. These voting agreements, combined with Zuckerberg's ownership of Class B stock, allow Zuckerberg to control approximately 55% of the votes.

3. **Zuckerberg is primarily donating shares of stock in Facebook, Inc., rather than cash, thus avoiding the recognition of capital gain on the contribution to the LLC.** Prior to the initial public offering of Facebook stock in 2012, Zuckerberg made donations of cash to nonprofit organizations. To do so, he had to first sell the stock, and the sale of the stock would increase his income tax bill. Now that Facebook is publicly traded, Zuckerberg has typically donated stock, rather than cash, to nonprofit entities. In doing so, Zuckerberg avoids recognizing any capital gain on the contribution and receives a charitable income tax deduction, thus decreasing his tax bill.

   Zuckerberg will likely convert Class B stock into Class A stock prior to the LLC donating the stock; this will drastically reduce the voting power of the donated stock, thus allowing him to retain his majority position.

4. **Zuckerberg has only made a pledge to make a donation of the stock or cash resulting from the sale of the stock.** Charitable pledges can be a fantastic starting point for making a donation because they are relatively open ended. However, unfulfilled charitable pledges are generally not legally enforceable, particularly in this situation, when Zuckerberg has not pledged to donate stock to a specific organization. In addition, Zuckerberg will not receive a tax deduction for the pledge until the stock (or anything of value) is actually transferred to a charity.

5. **Zuckerberg has historically implemented tools to decrease his exposure to the estate tax.** In May 2014, Zuckerberg gifted approximately four million shares of stock to various trusts that he formed for estate tax purposes. Zuckerberg has formed at least four Grantor Retained Annuity Trusts (GRATs) and currently serves as trustee of these trusts. These trusts are primarily funded with Class A stock. Zuckerberg has several other trusts, including the Openness Trust. Ironically, the purpose of the Openness Trust is unknown.

In summary, by careful planning, Zuckerberg should be able to maintain his majority voting position in Facebook for the foreseeable future, all while maintaining a large degree of privacy with regard to his charitable contributions.

Philanthrocapitalism and Impact Investing: Not Your Father's Philanthropy

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There has been a lot of media attention (and confusion) surrounding the Chan Zuckerberg Initiative and its non-standard structure. As described by Ginger Skinner in her article elsewhere in this issue, Mark Zuckerberg and Priscilla Chan chose to use a non-charitable limited liability company as their vehicle to improve "this world for the next generation." *See* Mark Zuckerberg letter to newborn daughter Max posted on his Facebook page. While the scope of their intended investment, up to $3 billion over three years, is uncommon, their non-traditional approach reflects a recent trend towards philanthrocapitalism and impact investing.

Philanthrocapitalism is an emerging trend among entrepreneurs to utilize the approaches and tools of the for-profit world to address many of the problems traditionally considered the realm of charities and governments. The term "impact investing" describes the approach of considering the social or environmental impact of an investment along with its expected financial return. This desire to evaluate the expected impact of a business's activities alongside the anticipated profits has led to some states creating new business entities such as benefit companies (see those allowed by ORS 60.754) and low-profit limited liability companies (a hybrid structure designed to allow a business to obtain program-related investment funding from private foundations while also obtaining funding from more traditional for-profit investors).

Many of the individuals who have chosen to move towards philanthrocapitalism have come from the tech industry. Pierre Omidyer, co-founder of eBay, created the Omidyar Network, a hybrid structure of a for-profit limited liability company and a related private foundation. Laurene Powell Jobs, the widow of Apple co-founder Steve Jobs, started the Emerson Collective, a charitably focused for-profit limited liability company. And Google.com initially created a subsidiary, Google.org, as a vehicle for both making grants to non-profits and investing in projects related to Google products.

Clients with charitable intentions have many reasons why they might choose a charitable for-profit entity, as opposed to a private foundation, to carry out their altruistic desires. They may believe that the entrepreneurial spirit that is fostered in for-profit enterprises is better equipped to tackle today's problems. Or they may be more comfortable with the for-profit model due to their business background. There are also numerous tax reasons why they may find a non-traditional approach more appealing. The list below highlights a few, but not all, of the tax considerations that may motivate clients to choose a charitable for-profit entity, as opposed to a private foundation, as a vehicle to achieve their philanthropic goals.

<u>The Client May Not Need an Immediate Income Tax Charitable Deduction.</u> Donors to private foundations or public charities are entitled to an immediate income tax deduction subject to limitations based on the donor's adjusted gross income and the type of asset donated. Unused deductions can be carried forward five years. IRC §170(d). A client may not have significant income in relation to the size of the gift he or she is considering. Someone like Mark Zuckerberg has relatively little income in comparison to the magnitude of his intended transfer to his LLC. By using a charitable for-profit entity, the client receives a charitable income tax deduction only when grants are made to public charities. This may allow the client to receive an income tax benefit well beyond the five years provided by the charitable contribution carryover. In addition, the income tax deduction generated by a donor's contribution to his or her private foundation will likely be limited to 30% of the donor's adjusted gross income, whereas contributions to a public charity have a higher limitation of 50% of adjusted gross income. Therefore, under some scenarios it is possible that the use of a charitable for-profit entity could result in a larger income tax deduction for the client.

<u>The Client May Want to Fund Their Charitable Interests with Business Interests While Retaining Significant Ownership of the Business.</u> Private foundations are subject to the excess business holdings rules of IRC § 4943, which limit the percentage ownership interests a private foundation can retain, beyond five years, in an active business. The rules are complex but can limit a private foundation's permitted ownership to 2% of a company's stock or profits interest if a substantial contributor to a foundation, its officers and directors, and the family members of the foregoing own 20% (and in some situations 35%) or more of the company's voting stock or profits interest. The excess business holding rules will prevent a client from funding a private foundation with business interests while retaining a significant ownership interest in the business. A transfer to a charitable for-profit entity will not have similar restrictions.

<u>The Client May Want to Fund Political Causes.</u> Private foundations are prohibited from campaigning for or against candidates for political office or engaging in significant lobbying. IRC § 501(h). A client who wants to use a multi-pronged approach that includes political activity and lobbying to tackle a problem might prefer the flexibility of a charitable for-profit entity.

<u>The Client May Want to Maintain Privacy.</u> Private foundations with gross receipts in excess of $25,000 per year are subject to extensive public disclosure requirements. On their annual tax returns, Form 990-PFs, private foundations must list all grants made; compensation paid to officers, directors, and the five highest paid employees; value of the foundation's assets; and revenue and expenses. A private foundation must make its three most recent tax returns available to anyone who requests them or disclose the returns on the internet. A client who would prefer to keep this information private can avoid these public disclosure requirements though the use of a charitable for-profit entity.

<u>The Client May Want to Retain the Ability to Engage in Transactions with the Entity.</u> Substantial contributors to private foundations are subject to the self-dealing rules of IRC § 4941. These rules prevent the donor, and his or her family, from engaging in almost any business or financial transaction with the private foundation. This includes charging rent when leasing property to the private foundation, charging interest when lending money to the foundation, or transferring debt-encumbered property to the private foundation when the foundation assumes the liability for the debt and the debt was placed on the property within the last 10 years. Most importantly for many clients, the self-dealing rules prohibit the donor from re-purchasing assets from the private foundation, even for an amount in excess of their fair market value. Once the donor transfers the asset, he or she will be unable to get it back at any cost. A client who wants to retain the flexibility to transact with the entity in the future would be better served by using a charitable for-profit entity.

<u>The Client May Want the Flexibility to Limit the Size of Annual Grants.</u> A private foundation is required to annually distribute at least 5% of the value of its endowment. IRC § 4942. A client intending to make a significant gift might have concerns that in a given year the foundation might not be able to identify suitable charities and programs that it wants to fund and would be unable to meet the distribution requirement. For example, if Mark Zuckerberg funded a private foundation instead of using an LLC, the foundation would be required to distribute

approximately $150 million annually. Particularly if a client wants to focus his or her resources to combat a specific problem, or focus on a specific geographic area, the annual distribution requirements may be untenable. By using a charitable for-profit entity, the client can better control the timing of distributions.

There are many different approaches to help clients implement their charitable goals. In some situations it may be beneficial for clients to consider non-traditional methods and newer business structures as opposed to, or in conjunction with, private foundations. For some clients, the tax issues related to private foundations make charitable for-profit entities a better option.

Distinguishing Significant Settlement Agreement Provisions

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When considering settlement terms, how do we decide whether a waiver, release, indemnification, or hold harmless provision is appropriate in our estate and trust settlements? These legally distinct terms are commonly misunderstood or mistakenly used interchangeably. The purpose of this article is to define and differentiate several significant settlement terms. In doing so, we are reminded of the necessity for awareness and precision in contemplating settlement agreements. Provisions that may appear within a trust agreement, such as an exculpation clause (which are governed by ORS 130.835 and *Mest v. Dugan,* 101 Or App 196 (1990)), are not addressed in this article.

Waiver

A "waiver" is defined as "[t]he intentional or voluntary relinquishment of a known right…." *Waiver, Black's Law Dictionary* (6th ed. 1991). The purpose of a waiver is for a party to voluntarily give up a personal right they have, such as the right to sue or the right to inheritance. A party's waiver of contractual rights is ordinarily unilateral and does not require consideration in order to be binding. *See Mitchell v. Pac. First Bank,* 130 Or App 65 (1994). Although waivers have pitfalls and require careful analysis and drafting, waivers can block liability.

When analyzing the terms of a waiver, it is important to explore who should provide a waiver and whose rights or duties should be waived. Another fundamental requirement for a valid waiver is that the party is both voluntarily and mentally capable of waiving their personal rights. Sample waiver language includes "in consideration of this Agreement, Beneficiary waives his beneficial interest, any right to further notices, accounting and information from the Trustee or the other beneficiaries of the Trust and any right to object to the further action by the Trustee outside of the obligations under this Agreement."

Release

A "release" is defined as "discharg[ing] a claim one has against another…." *Release, Black's Law Dictionary.* The function of a release is to surrender the right to sue or bring a claim against another party. Because a release is a contract between the parties, a valid release requires an exchange of valuable consideration. Particular language is not required to constitute a valid release, provided the language is complete and clearly indicates the intent of the party providing the release.

When assessing the terms of a release, it is necessary to explore who is being released and who is releasing claims. Whether the release is intended to be mutual among the parties or unilaterally restricted to certain parties is another factor to consider and negotiate. This analysis will illuminate whether a party found their way into the settlement agreement whose release was not intended and negotiated for during negotiations. Another factor to analyze is whether a general release of all claims is relevant or only specific claims should be released. A general release encompasses all claims in existence between the parties that are known and contemplated when the release is executed. A specific release is generally limited to specific or limited claims detailed in the agreement.

A release of liability for breach of trust given upon termination of a trust will be invalid, however, if it was induced by the trustee's improper conduct, or the beneficiary did not know their rights or the material facts relating to the breach. ORS 130.730(3)(a) and (b). Factors that may affect the validity of a release include, but are not limited to: adequacy of disclosure, whether the beneficiary was financially or legally incapable, whether the beneficiary was represented by counsel, and whether the trustee engaged in any improper conduct. Valerie J. Vollmar, *The Oregon Uniform Trust Code and Comments,* 42 Willamette L Rev 187, 377 (2006).

An example of mutual release language is "in consideration for the terms of this Agreement, the Parties fully and completely release all other Parties from any claims, demands, causes of action, liabilities, and expenses, known or unknown, or could not have been known, asserted or unasserted, arising out of or related to the Action, the Trust, and/or the Estate of the decedent."

How Are Waivers and Releases Different?

A waiver is the personal act of abandoning one's right or claim. So a waiver focuses on an individual's personal rights and what is happening with those personal rights, such as a beneficiary or a fiduciary in their personal capacity. In contrast, a release is the act of freeing or relieving someone else from their responsibility, obligation, or liability. So a release focuses on the rights of another person or third party, such as the fiduciary for a beneficiary. Consequently, with waivers we would say, "I waive my personal rights" because our personal rights or duties are being relinquished. With a release, we would say, "you are released of your duties" because it relates to another party's rights and duties being discharged.

Indemnification

"Indemnification" means "[t]o restore the victim of a loss, in whole or in part, by payment, repair, or replacement." *Indemnification, Black's Law Dictionary.* A fundamental legal principle is that everyone should be responsible for any damage they have caused. Indemnification is a contractual obligation by one party to pay or compensate for the losses, damages, or liabilities incurred by another party to the contract or by some third person. The rules that govern the construction and interpretation of other contracts apply with indemnification agreements, and the parties' intention is paramount.

Indemnity functions as a means of shifting risk between parties to an agreement. An insurance contract is probably the most commonly known type of indemnity agreement, where the insurance company agrees to indemnify the insured against another party's wrongful conduct. Oregon courts generally do not favor indemnity, yet a party may be indemnified for a particular loss, even if the loss is caused by that party's negligence, as long as the contractual language is clear and explicit. *See Blanchfill v. Better Builds, Inc.,* 160 Or App 527 (1999).

To assess whether indemnity is relevant, ask, "should one party be liable to another party for potential future harm?" Indemnification clauses can be drafted broadly or narrowly to address when the payment of damages will occur, how the liability may be shifted, and the extent of such liability. Again, an analysis of who is being indemnified and who is indemnifying is necessary.

The Oregon Supreme Court describes indemnity in the following way, although the Court clarifies there can be no all-encompassing rule:

> "Indemnity is a shifting of responsibility from the shoulders of one person to another; and the duty to indemnify will be recognized in cases where community opinion would consider that in justice the responsibility should rest upon one rather than the other. This may be because of the relation of the parties to one another, and the consequent duty owed; or it may be because of a significant difference in the kind or quality of their conduct."

Piehl v. The Dalles Gen. Hosp., 280 Or 613, 621 (1977) (quoting William L. Prosser, *Handbook of the Law of Torts* § 51 at 313 (4th ed. 1971)).

Indemnification is a substantive component of a settlement and should be bargained for. The precise terms of the indemnification language are highly important, yet this factor is often overlooked. Before indemnification is requested or included in an agreement, ask whether potential future claims would justify encumbering the agreement with a comprehensive indemnification analysis and negotiated provisions. Requests for indemnification can be both displeasing to the other party and complex to draft, so unless indemnification is warranted, it should be avoided.

Example indemnity language taken from a standard residential real property listing agreement that a fiduciary may enter into is: "Seller shall defend, indemnify, and hold harmless Principal Broker and its licensees, and any cooperating broker and its licensees, from any liability, claims, damages, causes of action, or suits arising out of, or relating to, any breach of the representations and warranties set forth herein or in any agreement for the sale of the Property, and from the failure to disclose any material information to Principal Broker relating to the Property."

The Duty to Defend and Indemnification

Sometimes we see an indemnification clause that includes the duty to defend. The duty to defend is separate from and independent of indemnification. In contrast to an obligation to indemnify, a contractual obligation to defend requires the party to immediately and actively defend or fund the defense of any claim at the outset of the claim or litigation. So the contractual duty to defend arises before the duty to indemnify, because indemnity provides coverage after the damage or lawsuit. The duty to defend is closer in definition to, if not synonymous with, holding a party harmless.

Hold Harmless

"Hold harmless" is defined as when "one party assumes the liability inherent in a situation, thereby relieving the other party of responsibility." *Hold Harmless, Black's Law Dictionary.*

A hold harmless provision is an agreement to hold another party without responsibility for damage or other liability arising out of the situation. In brief, someone is asking you to agree to be sued instead of them, if something goes wrong. For example, instead of seeking to bar a lawsuit, a hold harmless agreement obligates one party to pay any costs the other party incurs as a result of a lawsuit.

There is a conflict in legal authority regarding whether a hold harmless clause is a form of indemnification per se. Oregon case law addressing a distinction between hold harmless and indemnification was not discovered, but other courts have held that "indemnify" and "hold harmless" are synonymous or duplicative, and courts tend to use the terms interchangeably. *See Medcom Holding Co. v. Baxter Travenol Labs., Inc.,* 200 F3d 518, 519 (7th Cir

1999); *Praetorian Ins. Co. v. Site Inspection, LLC*, 604 F3d 509, 515 (8th Cir 2010); *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A2d 572, 588 (Del Ch 2006).

However, a number of courts have recently held that the term "hold harmless" acts only as an exculpatory provision that releases the indemnitee from liability to the indemnitor. *See Exxon Mobil Corp. v. New W. Petroleum, LP,* 369 F App'x 805, 807 (9th Cir 2010); *Fernandez v. K-M Indus. Holding Co*., 646 F Supp 2d 1150, 1159-60 (ND Cal 2009).

Arguably, hold harmless does not give the recipient a right of indemnity against the claims of third parties, but only provides a defense against direct claims against it by the other party to the contract. Yet a properly drafted hold harmless agreement may have more teeth than a standard indemnification because the party bound by the agreement may be obligated to pay expenses as they arise rather than reimbursing expenses after they have been paid. A hold harmless agreement is also presumed to apply comprehensively to all costs for which the other party would be held liable, including the legal costs of responding to and defending against a claim, as well as the payment of any damages ultimately awarded to the claimant. This could be very broad and very burdensome.

Hold harmless language is often included with an indemnity, and a broad indemnity clause with a hold harmless clause may read: "Defendant specifically and expressly agrees to indemnify, defend, and hold harmless Plaintiff and its agents or representatives (hereinafter collectively 'Indemnitees') against and from any and all claims, demands, suits, losses, costs, and damages of every kind and description, including attorneys' fees and/or litigation expenses, brought or made against or incurred by any of the Indemnitees to the extent resulting from or arising out of any negligence or wrongful acts of Defendant and its agents or representatives in the performance or nonperformance of Defendant's obligations under this Agreement or in any way related to this Agreement."

Are Hold Harmless and Indemnification Truly Different?

Although hold harmless and indemnity are often viewed synonymously, many sources view them differently, and in that differentiation deem hold harmless as a broader remedy than the narrower remedy of indemnification. Arguably, one is offensive and the other is defensive, yet both deal with situations involving third-party liability. Indemnity is an offensive right, a sword allowing an indemnitee to seek indemnification, whereas hold harmless is defensive and includes the right not to be bothered by the other party seeking indemnification. *See Queen Villas Homeowners Ass'n v. TCB Prop. Mgmt.,* 56 Cal Rptr 3d 528, 533 (App 2007). Another court clarified that "[i]n the abstract, the word indemnify generally grants rights, and the phrase hold harmless generally limits liability." *Majkowski*, 913 A2d at 593 n.55.

Conclusion

Whether a waiver, release, indemnification, or hold harmless provision is relevant, fundamental considerations should first be analyzed in estate and trust settlements. Some key factors include: who the necessary parties are, whether consideration is exchanged, what the current problems to resolve are, what potential future problems may arise, and who should or should not be involved in certain settlement provisions. Once these considerations are analyzed, it should be apparent whether a release, waiver, indemnification, and/or hold harmless provision is applicable, and then those terms can be successfully negotiated and drafted.

Delivery of Required Notices to the Estate Administration Unit

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As many of you know, there are a number of notices in decedent's estates that the statutes mandate must be delivered to the Department of Human Services and the Oregon Health Authority. The Department of Human Services, effective August 1, 2016, is amending OAR 461-135-0834 to include ORS 115.003 and 116.093 notices. The new language is in bold and underlined below.

461-135-0834 Eff. 8-1-16

Delivery of Required Notices to the Estate Administration Unit

(1) A person required by ORS 93.268, 113.145, 114.525, 115.003, 116.093, or 130.370 to send notice to the Department of Human Services must send or deliver the notice to the Estate Administration Unit, Office of Payment Accuracy and Recovery, Department of Human Services.

(2) If a claim submitted by the Estate Administration Unit is disallowed, the notice of the disallowance, required by ORS 114.540, 115.135, or 130.400, shall be mailed to the Estate Administration Unit, unless the claim directs that the notice of disallowance be mailed to a person or entity other than the Estate Administration Unit.

(3) The mailing address for the Estate Administration Unit is:

Estate Administration Unit
PO Box 14021
Salem OR 97309-5024

Also, a reminder that the Oregon Health Authority has authorized certain notices be sent to the Estate Administration Unit, and may be combined with notices to the Department of Human Services.

Oregon Health Authority Rule OAR 943-001-0020(2)(e) (emphasis added),

> "(e) Statutorily required filings, notices or service of papers, applications, notices or other documents to be mailed, provided to, or served on the Authority shall be mailed, provided to, or served on the Authority. <u>Any notices required by ORS 113.145, 114.525 and 130.370 to be sent to the Authority may be consolidated with similar notices to the Department and sent to the Estate Administration Unit of the Department.</u> Any notices required by 416.530 to be sent to the Authority may be consolidated with similar notices to the Department and sent to the Personal Injury Lien Unit of the Department Any consolidated notice shall be considered notice to the Authority as long as the Authority's interest or claim in the matter is identified in the notice consistent with requirements in applicable statute."

I have requested the Oregon Health Authority to list ORS 116.093 in its rule as well.

Also note that the Oregon Health Authority has adopted, and incorporated by reference, all of the estate recovery rules in OAR Chapter 461. OAR 410-120-0006(1).

Another reminder that if the Department of Human Services or the Oregon Health Authority submits a claim to a decedent's estate, and the claim is not paid in full, the personal representative has a legal duty to give notice and opportunity to object to the Department of Human Services and Oregon Health Authority, through the Estate Administration Unit. ORS 116.093(4) and (5).

Events Calendar

Estate Planning and Administration Section CLE

What: Basic Estate Planning

When: November 18, 2016

Where: Double Tree Hotel, Lloyd Center, Portland

The Editors want to include announcements of upcoming events that are open to the public and may be of interest to our readers. If you know of an event, please send basic information, including point of contact information to Sheryl S. McConnell at *smcconnellor@aol.com* for inclusion in the next issue of the Newsletter.

Questions, Comments, Suggestions About This Newsletter?

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