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Charitable Estate Settlement: A Primer from the Charity's Perspective

By Gary Snerson, JD, Laura Peebles, CPA, and Bryan Clontz, CFP[1]

INTRODUCTION

As charitable bequests and legacy gifts continue to rise, an increasing number of charities are either anticipating or reacting to the estate settlement process. If the estate settlement is not handled properly, gifts may create direct and indirect liabilities, shrink, be delayed, result in litigation, or be impossible to administer.

This article aims to outline the charitable estate settlement process from the perspectives of the donor, the charity, and even the donor's surviving family.[2] It begins first by considering the form of the gift and resulting tax implications — the actual estate planning. Then it discusses consequences of these gifts to charities. It then outlines a model procedure for donors. Finally, it lists eight potential pitfalls in the charitable estate settlement process.

ESTATE PLANNING

There are two main considerations during the charitable gift planning process to consider with the settlement process in mind. The first is the how the donor owns the assets that are destined for charity, which can affect whether there will be any need for probate before the assets can be transferred to the charity. The second is the tax implications of the chosen gift, both relating to estate and gift taxes, and lifetime and estate income taxes. This section discusses bequests in wills or revocable trusts, beneficiary designations, charitable remainder trusts (CRTs), and charitable gift annuities (CGAs).

The most simple, and obvious, gift from an estate planning perspective is the charitable bequest. This form of gift simply leaves property to a named charity in the donor's will or revocable trust.[3] This is by far the most common way to leave a charitable legacy — around 80% of planned gifts are will bequests.[4] Much of their appeal comes from their relative simplicity, as well as their flexibility. Only assets the donor did not consume during life are committed, and even then the gift is revocable and modifiable.[5] Should the donor's estate be subject to the estate tax, the bequest will reduce the size of the taxable estate.[6] However, the donor gets no tax benefit during his or her lifetime, unlike some other forms of gift.[7]

Another simple form of gift is the beneficiary designation, which may be described as a gift by contract. This is easy for donors to make because it does not even need to be included in a will.[8] Indeed, a will provision cannot override or affect a beneficiary designation. Therefore, these gifts avoid the probate process. Beneficiary designations can be made on financial devices as diverse as retirement plans, IRAs, life insurance contracts, and pay-on-death bank accounts, among others.[9] Depending on the asset, designations can reduce estate taxes using the estate tax charitable deduction and avoid income taxes because the chari-

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[1] All authors are associated with Charitable Solutions LLC, Jacksonville Florida, charitablesolutionsllc.com.

[2] This paper does not include any of the special estate administration and tax rules applicable to private foundations. Those will be covered in a future paper.

[3] Throughout this paper, the term "will" should be read to include a revocable trust used as a testamentary substitute.

[4] *Bequest-Like Gifts That Don't Require a Will*, PG Calc (Feb. 2011), *available at* http://www.pgcalc.com/about/featured-article-february-2011.htm.

[5] *Id.*

[6] Rachel Emma Silverman, *The Quest for the Right Bequest*, Wall St. J. (Oct. 1, 2011), *available at* http://www.wsj.com/articles/SB10001424052970204010604576594790543894476.

[7] *Id.*

[8] PG Calc, above n. 4.

[9] *Id.*

ISSN 0886-3547

table beneficiary is income tax exempt.[10] The donor's assets are not impacted during life, and the charity simply receives the remaining balance or a predetermined amount on death. For a beneficiary designation on life insurance, there is an estate tax deduction available, but not against lifetime taxable income (unless the ownership of the policy is also transferred to the charity before death).[11] IRAs and retirement plans can allow tax deductions on both estate and income taxes, but these deductions are much more complex.[12] It is crucial to determine if the plan permits a charitable beneficiary to be named. In addition, for married donors, all qualified plans are subject to one of two forms of federal spousal rights, but those can be waived by the non-participant spouse to allow a full or partial charitable designation.

If the donor wishes to give the charity a gift in the most tax-efficient manner, the most likely asset to use is an IRA or qualified plan. If those assets are distributed to a non-charitable beneficiary, the recipient generally will pay income tax on them. Therefore, most planners recommend designating a charity as the beneficiary of an IRA as a means of fulfilling a charitable gift. However, over time, the value of those accounts may shrink due to investment losses, required minimum distributions, and voluntary withdrawals from the account by the owner. Therefore, if the donor wants the charity to receive an amount certain, a back-up clause in his or her will may be needed: something along the lines of "to the extent that Charity does not receive at least $1M from my IRA accounts, I hereby bequeath to Charity the difference between $1M and the date of death value of my IRA accounts, to be funded by assets selected by my executor."

Thinking about IRA designations, it may be wise to back up that designation with a bequest of the IRA under the donor's will. Due to the number of bank mergers and changes in custodianship of IRAs over time, the charitable beneficiary designation may be misplaced by the custodian. Although not as efficient for tax or administrative purposes as an outright beneficiary designation, passing the IRA through the estate and on to the charity is better than losing out entirely.

If a donor has an outstanding charitable pledge, and that pledge is enforceable under state law, then the charity has standing as a creditor, rather than as a beneficiary under the will or trust. This generally will result in quicker payment of the amount remaining on the pledge, as creditors must be paid before even specific legacies.[13]

Pay-on-death accounts have limited tax benefits, but are deductible in calculating the taxable estate as a charitable bequest. Pay-on-death accounts can backfire on the donor and the charity if the charity is not properly named. In such a case the non-charitable beneficiaries may claim that the gift was not completed. Such a claim is likely if the debts, taxes, and expenses of the estate exceed the available liquid assets in the probate estate or substantially impact the beneficiaries taking through the probate estate.

CRTs are more complex instruments, both from planning and tax perspectives. They require carefully prepared documents that comply with IRS regulations, to ensure the most favorable tax treatment. They come in two flavors — inter vivos and testamentary. Essentially, an inter vivos CRT works by transferring assets in trust during the donor's lifetime.[14] The donor retains a life annuity or unitrust interest, and receives distributions from the trust.[15] Married donors often give their surviving spouse a successor life interest. CRTs can also be established at death through a will or trust provision with the spouse or another individual as a beneficiary. Upon the death of the last income beneficiary (or the term of the trust for term CRTs), the trustee transfers the assets to the charitable remainderman subject to the terms of the trust document.

CGAs are contracts between the donor and the charity. The asset or assets used to create the CGA belong to the charity upon transfer. Therefore, there is no transfer on the death of the donor unless the CGA is created by the donor's will. If the CGA was created during the donor's life, which is usually the case, the death of the donor relieves the charity of any further responsibility to make future payments. The exception would be when the CGA is a joint and survivor annuity and the spouse survives the donor. Because of the timing of the payments by the charity, and possible

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[10] Timothy S. Midura, *Handling Charitable Bequests and Charitable Trusts*, *in* Illinois Estate Administration 11-8 (Charles F. Newlin ed. 2009), *available at* http://www.timothymidura.com/uploads/Charitable_Bequest_Administration_-_Midura.pdf.

[11] Veronica Dagher, *Donating a Life-Insurance Policy to a Charity*, Wall St. J. (Sept. 18, 2013), *available at* http://www.wsj.com/articles/SB10001424127887323608504579022743817392368.

[12] *Tips and Traps on Retirement Accounts and Other Charitable Beneficiary Designations*, Am. Inst. for Cancer Research 6–7 (2014), *available at* http://www.aicr.org/assets/docs/pdf/estateplanner/2014-tips-traps-on-retirement-accounts-tra.pdf.

David Donaldson & Carolyn M. Osteen, The Harvard Manual on Tax Aspects of Charitable Giving 166-67 (Martin Hall & Carolyn M. Osteen eds., 9th ed. 2011).

[13] Beckwith and Allan, 839 T.M., *Estate and Gift Tax Charitable Deductions*.

[14] Paul H. Gessaman, *Charitable Remainder Trusts and Charitable Annuities as Estate Planning Tools*, NebFacts (Jan. 1, 1996), *available at* http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1679&context=extensionhist.

[15] *Id.*

ISSN 0886-3547

delays in the charity becoming aware of the annuitant's death, it is possible that the decedent's estate may owe the charity a portion of the payment already made or the charity may owe the estate a portion of the payment to be made. In either case, the charity should make the executor aware of these circumstances.

CONSEQUENCES TO CHARITIES

How do charities treat gifts left to them as part of estate planning? The answer depends on the form of the gift (discussed above for donors), as well as the nature of the gift. These factors combine to inform both how (the value) and when (the recognition) the charity reports the gift. Further, although charities are exempt from income taxes due to their 501(c)(3) status, they may still be impacted by tax issues relating to settlement of the whole estate in which they have an interest.

Determining the value of gifts is an important task for charities. Not only can the true value of a gift sometimes not be immediately ascertainable, deferred gifts such as CRTs can have uncertain values. Add to this, gifts that could be revoked such as payable-on-death accounts or life insurance beneficiary designations, and it is sometimes unclear whether a completed gift has been made at all. Even if a beneficiary designation on a policy is irrevocable, if there are future premiums due, failure of the donor to pay the future premiums could cause the gift value to diminish or vanish. Therefore, determining the value of a gift can be a complex task.

The easiest gifts to value are, of course, outright cash gifts — they are given full value.[16] However, many outright gifts do not have that immediately discernible value; even though the charity has access to them (the assets are "available for the charity's current use").[17] If the donor imposes a restriction on the use of the asset it may adversely impact the value of the gift.[18] In that circumstance, the generally accepted practice is to determine the fair market value.[19] In some cases, this is easy, such as when the gift takes the form of publicly traded securities.[20] However, if there is no readily ascertainable value, there may need to be an appraisal, or utilization of "valuation techniques, such as the present value of estimated future cash flows."[21] Similar financial valuation techniques will need to be deployed for deferred gifts, like CRTs, that have a definite value to the charity when the trust is funded, even if the assets are not immediately available.[22] Valuation of all CRTs whether trusteed by the charity or by an outside organization must be valued and reported annually under The Financial Accounting Standards Board (FASB) rules. These rules now also apply to realized bequests that have not yet been funded and/or paid. Revocable gifts (a bequest in a will or revocable trust, or a beneficiary designation of retirement plan assets, for example) require a similar calculation, where the probability of the gift eventually being made should be taken into account in valuing the gift.[23]

Special consideration should be given to illiquid gifts, such as artwork, mineral rights, or intellectual property rights. These sorts of gifts tend to require special care and expertise when it comes to valuation. FASB recommends that donated artwork and historical treasures be recognized normally if the items meet a number of requirements relating to display, care, and disposal.[24] Mineral rights are more complex, and charities receiving such gifts must do extensive (and sometimes costly) due diligence,[25] including investigating the legal title status of the rights.[26] Ancillary probate proceedings may be required to establish such legal title. The value of intellectual property such as copyrights or website domain names should not be overlooked. A bequest of a work of art may or may not include the copyright: whether that is included or

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[16] *Guidelines for Reporting and Counting Charitable Gifts*, P'ship for Philanthropic Planning 14 (2009), *available at* http://media.wix.com/ugd/2ec486_1cf05006f752475c828b789a595ac771.pdf.

[17] Jeffrey Comfort & Robert Sharpe, Jr., *Valuation Standards for Charitable Planned Gifts*, P'ship for Philanthropic Planning 16 (2011), *available at* http://media.wix.com/ugd/2ec486_5068c78e38044f1a8843bf1987075d0b.pdf.

[18] Donaldson & Osteen, above n. 2, at 25–26 (citing Rev. Rul. 85-99, 1985-2 C.B. 83; GCM 393801 (July 9, 1985); and PLR 8812003).

[19] *Statement of Financial Accounting Standard No. 116: Accounting for Contributions Received and Contributions Made*, Fin. Accounting Standards Bd. 8 (1993), *available at* http://www.fasb.org/resources/ccurl/770/425/fas116.pdf.

[20] *Id.*

[21] *Id.*

[22] Comfort & Sharpe, above n. 17, at 16.

[23] Of course, this discounting is necessarily inexact, and should only be used internally. *Id.* at 23–24.

[24] Fin. Accounting Standards Bd, above n. 19, at 7. Specifically, these conditions require that the art or treasures: "a. Are held for public exhibition, education, or research in furtherance of public service rather than financial gain[;] b. Are protected, kept unencumbered, cared for, and preserved[;] c. Are subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections."

[25] Katelyn Ferral, *Mineral Rights, Royalties Flowing to Western Pa. Charities*, Tribune-Review (Nov. 2, 2014), *available at* http://triblive.com/business/headlines/7003166-74/rights-mineral-gas#axzz3VtC9MIMh.

[26] Joe Hancock, *Black Gold: Gifts of Oil and Gas Interests Made Simple*, Okla. Planned Giving Council 8 (Sept. 10, 2009), *available at* http://www.okpgc.org/uploads/Joe_Hancock_Black_Gold_9-10-09.pdf.

ISSN 0886-3547

not will significantly affect the value. Executors and administrators unfamiliar with these matters may need specialized counsel.

The other factor charities must consider is when they should recognize the gift. For example, if a donor has irrevocably pledged life insurance (with the charity as the policy beneficiary), the value of that gift might be easily determined, but the time at which it is recognized is not immediately clear. As indicated above, charities should consider requiring the donor to transfer ownership of the policy along with the beneficial interest at the time of the gift. If the policy is not fully paid up at the time of the gift, arrangements must be made for future premium payments, or conversion to a paid-up policy, to avoid a policy lapse. If the donor pays the premiums after the charity owns the policy, the donor is entitled to additional tax deductions for the amount paid. As a baseline, consider an inter vivos gift of cash, which clearly would not be part of any estate settlement process. This outright gift can "be recognized as revenues . . . in the period received."[27]

This is the general approach which should be taken — contributions should be recognized when received. FASB recommends that "unconditional promises to give" be recognized as received when the promise was made, rather than the asset actually received.[28] However, "to be recognized in financial statements there must be sufficient evidence in the form of verifiable documentation that a promise was made and received."[29] Usually this takes the form of an irrevocable pledge binding the donor and the donor's estate. For assets pledged in a bequest that was revocable during the testator's lifetime, once the donor dies, the charity can recognize the value of those assets before the assets become available, because the bequest is irrevocable once the testator-donor dies (see comment above). A similar approach could be taken for a pay-on-death bank account or life insurance. For CRTs (whether inter vivos or testamentary) and CGAs, the assets are received when the irrevocable document or trust comes into effect (although the valuation question is more difficult, as discussed above).

Another consideration for the recipient charities is the interaction between taxes during estate administration and bequests to the charities. These taxes can include both the estate tax and income taxes. Although estates (and some trusts) can deduct from income amounts distributed to charities, the charitable beneficiaries should work with estate executors to ensure that they receive everything the donor intended.[30] Charities should be similarly careful with regard to the estate tax, when that tax has been apportioned to a charitable residue.[31] They should review estate tax clauses and returns to make sure that any tax payments by the executor were in accordance with the donor's expressed intent.[32] Suggestions for specific due diligence are discussed in the next section.

RECOMMENDED PROCEDURE

This section broadly outlines how a charity should go about contributing to a smooth and equitable estate settlement process. This process includes estate planning, post-mortem communication with the executor, investigation of non-probate gifts, and working with the executor, the professionals, and surviving family on administration issues. Maintaining open lines of communication with all parties involved is essential to not only individual estates, but to good relationships with the community and potential donors in general. Depending on the size and experience of the charity, it may have more experience with charitable estate administration than the executor and his or her accountants and attorneys.

Recommendations During the Estate Planning Process

The groundwork for smooth estate settlement is laid during the planning process. When a potential donor approaches the charity about a gift, the nonprofit should help determine the form and extent of the donor's charitable intent.[33] This includes figuring out what the donor wishes to accomplish, and how much and when he or she wants to give.[34] Once a decision to give has been made, the charity should engage with the donor's professional advisors — his or her attorneys, accountants, and investment advisors, among others. Such due diligence can avoid complications when the donor dies and his or her intentions are no longer discernible. Family dissatisfaction with the estate plan can lead to disagreements during the probate

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[27] Fin. Accounting Standards Bd, above n. 19, at 6.

[28] *Id.*

[29] *Id.* Further, if no clear promise was made, the gift may still be considered received if there is an unconditional intention that is legally binding.

[30] Lawrence P. Katzenstein, *Estates with Charities as Beneficiaries: How Do We Protect Their Interests?* Saint Louis Planned Giving Council 1 (2011), *available at* http://www.slpgc.org/files/Handouts_2011/SLPGC_Lunch_Handout-estates_011311.pdf.

[31] *Id.* at 5–11.

[32] *Id.* at 9.

[33] Richard Livingston, *Charitable Giving Methods: What Nonprofits Need to Know — And Need to Tell Their Donors*, Colo. Planned Giving Roundtable 2 (2005), *available at* http://www.cpgr.org/lal/files/File/uploads/Methods.pdf.

[34] *Id.*

ISSN 0886-3547

process and often costly litigation.[35] The goal of all involved should be "to maximize the tax benefits and impact of the donation on [the donor's] estates, families, and the philanthropic causes they wish to support."[36] Ideally, the donor, the donor's family, the advisors, and the charity should all be fully informed and prepared to proceed when the time comes for the actual gift transfer to occur. Part of the planning process is to confirm that the assets are the type that the charity wants to receive, and is able to accept under their gift acceptance policy. If the estate includes assets that the charity does not want, but that have value, the time to deal with that issue is during the planning process if at all possible. Perhaps the will or trust should include instructions to the executor for the disposition of the assets during estate administration. Alternative dispositions to family members or other charities should be considered. "Assets a charity does not want to receive" vary depending on the size and type of charity, but mortgaged real estate, collectibles, and family business interests are typically not preferred gifts.

Another advantage of being involved in the planning process is to discuss with the donor the possibility of lifetime gifts of some of the assets. Generally, there will be an income tax advantage of lifetime gifts over testamentary gifts.

Of course, not all donors involve the charity in the planning process. Perhaps the testator does not want to be contacted during his or her lifetime, or perhaps he or she wants to be able to quietly change the charity up to the last minute without making a permanent commitment to his or her chosen charity or charities. Whatever the reason, it is typical for the charity to find out about the bequest only after the death of the donor. Despite major efforts by charities to identify and catalogue potential bequest donors, most bequests come from donors who were either unknown to the charity or were known but had never indicated an intention to make a bequest. Normally, the charity is informed by the executor, but sometimes the information becomes public even before the charity has been contacted.

[35] Betsy Brill, *Incorporating Philanthropic Planning Adds Value to Your Client Services and Makes Good Business Sense to You*, The Journal of Practical Estate Planning (2002), *available at* http://www.pgdc.com/pgdc/incorporating-philanthropic-planning-adds-value-your-client-services-and-makes-good-business-sense-you.

[36] Philip Herzberg, *Promoting Philanthropic Giving in Current Estate Plans*, Journal of Fin. Planning, *available at* http://www.onefpa.org/journal/Pages/JUN14-Promoting-Philanthropic-Giving-in-Current-Estate-Plans.aspx.

Actions Immediately Following the Donor's Death

The next phase of the process begins when the charity receives notice of the donor's death. For charities, the next steps involve "reviewing documents, providing needed information, monitoring progress, and stewardship."[37] Ultimately, the charity's goal is "ensuring your non-profit receives the amount it is entitled to, as quickly as possible."[38] Abatement — when the estate is insufficient to pay all legacies in the will — may reduce the charitable gift, if it is made from the residuary estate or a general legacy of cash.[39] Ademption — where the specific asset that was bequeathed no longer exists, can eliminate the charitable gift entirely.

Typically, the estate's executor[40] notifies the charity that the donor has died, and has left a bequest to the charity.[41] In probate estates, such notification is often required by law. The charity should obtain a copy of the will, or if applicable, the trust agreement. In the case of a will, which once filed is a public document available for inspection in the probate court for the county in which the donor last lived, it is common to receive a copy of the will from the executor. If the donor had a revocable trust, it may be inappropriate to request a copy of the full trust document, at least initially, but it would be common to at least be provided an excerpt that shows the gift. Depending on the size and nature of the gift, the complexity of the estate, the impact of taxes, and the donor's family situation, the charity may need to see other provisions of the document, especially clauses allocating taxes and administrative costs among the beneficiaries. The charity and its counsel should immediately review the relevant documents.

Bequest Is a Fixed Amount

If the bequest is a fixed amount (a pecuniary bequest), these are some of the subjects for discussion:

- Does the executor expect there will be sufficient liquid assets to fund the bequest without waiting for the estate to sell illiquid assets?

[37] Alison O'Carroll, *Bequests — Stewardship and Administration*, Northwest Planned Giving Roundtable 14 (July 19, 2013), *available at* http://www.nwpgrt.org/Mbrmtg/7.13_Handout_BequestsStewardshipAndAdminPaper.pdf.

[38] *Id.*

[39] Katzenstein, above n. 30, at 6.

[40] Executor also refers to the successor trustee under the decedent's formerly revocable trust.

[41] Aviva Shiff Boedecker, *What to Do When the Donor Dies – Understanding Estate Administration Rights and Responsibilities of Charitable Beneficiaries*, Sharpe Group (May 1, 2012), *available at* http://sharpenet.com/give-take/donor-dies-understanding-estate-administration-rights-responsibilities-charitable-beneficiaries/.

ISSN 0886-3547

- Are there expected to be any challenges to the estate documents, or to the specific bequest?
- If there are sufficient liquid assets, and no expected challenges, then a general inquiry as to when a full or partial payment might be expected is in order. If the estate is large enough that federal (and state) inheritance tax returns will need to be filed, the executor may be unwilling to pay any bequests until he or she receives a federal and/or state closing letter or, if there is no estate tax audit, until the applicable statute of limitations has run (this may be as long as 4 years and 3 months after the date of death). Given that executors may be personally charged by the IRS if they pay bequests while leaving insufficient funds in the estate for any taxes, this reluctance is understandable.[42] If the charity has substantial net worth, it should offer to sign a receipt, release, and refunding agreement in order to achieve early partial or full payment so as to minimize any opportunity cost associated with delayed payment. State law typically provides for interest on delayed payment of bequests.
- Offer to provide any relevant paperwork, such as a copy of the IRS exemption letter or any state registration that might facilitate the executor's work.
- If the bequest is a fixed amount of money less any payments made under a pledge agreement prior to the date of death, the charity should review its records and provide its list of relevant payments, as the executor will need that information before making the payment under the will.
- If the executor indicates that the estate is composed primarily of illiquid assets, or there are other reasons that full payment might be delayed (such as expected IRS disputes over valuation, litigation with heirs, assets with unclear title or environmental issues, or potentially insufficient assets to fund all specific bequests), then the charity should retain experienced local probate counsel to advise it of its rights under the relevant state law and the documents.
- If the estate is composed of illiquid assets, gain an understanding of the executor's plan for valuation and liquidation of those assets. If the appraised value of those assets is equal or greater than the amount of the bequest, the charity should consider taking them in lieu of cash if there is the perception that a hasty liquidation may decrease the value of the bequest. If the bequest is relatively small compared to the overall estate, then there is less concern with those issues than if the bequest is such that the net realizable value of the assets would affect the ability to fully fund the bequest. Any in-kind settlement agreement may require approval by a court or state charity official which may require the charity to consult counsel.

Bequest Is Either All or a Portion of the Residue of the Estate

If the bequest is either all, or a portion, of the residue of the estate, there are additional issues that should concern the charity. Discerning the quality of the bequest is important in determining what its treatment should be during the settlement process, and can have economic implications for all beneficiaries, not just the charity.[43]

Executor's Plan for Distribution of the Assets in the Estate

Unless the will or trust instructs otherwise, the executor may want to value the assets, and then distribute them to the charity (and possibly other heirs) in kind in the interest of closing the estate promptly. If that is his or her plan, a close review of the assets is in order. If the estate is composed of marketable securities and a condominium, this might be acceptable. On the other hand, if the estate contains assets that would generate unrelated business taxable income for the charity (such as leveraged real estate, publicly traded partnerships, Subchapter S Corporations), the net after-tax proceeds to the charity are likely to be greater if those assets can be sold in the estate or trust.[44] If the estate includes assets that would not be typically accepted by the charity under their gift acceptance policy (e.g., hedge funds, leveraged real estate, closely held business interests, mineral interests, general partnership interests, complex financial instrument contracts, undeveloped real estate, tangible personal property, undivided interests, timber and art that is un-accessionable), significant negotiations may be needed to avoid that outcome.

Counsel should be engaged to review the documents to determine if the charity can insist that the executor liquidate the assets before closing the estate. If the documents restrict the executor's actions or the executor is unwilling to exercise his or her powers to liquidate the problematic assets and distribute the proceeds to the charity, local counsel should be engaged to explore the possibility of asking the probate court for an order expanding the executors powers under

[42] *United States v. Stiles*, No. 2:13-cv-00138-JFC, 2014 BL 338556 (W.D. Pa. Dec. 2, 2014).

[43] Midura, above n. 10, at 11-8.

[44] Generally, estates are not subject to the unrelated business income tax.

ISSN 0886-3547

applicable state laws or entering an order forcing the executor to act.

If liquidation before distribution is not possible, then plans should be made well in advance for disposition of the unwanted assets. It may be desirable to ask the executor to transfer the assets to a single member LLC to avoid placing the charity in the direct chain of title if there is real estate or mineral properties included in the estate assets that will be transferred to the charity. Another alternative is to transfer the illiquid assets to a dedicated fund at a donor-advised fund with experience in liquidating such assets.

After liquidation, the net proceeds after taxes and fees would be transferred to the charity. Certain donor-advised funds are designed to minimize the income tax that would be due on disposition of assets subject to the unrelated business income tax. If the estate assets include Subchapter S stock,[45] debt-financed property of any kind,[46] or other assets subject to the tax,[47] it will generally be worthwhile to use a donor-advised fund for this purpose, as the tax savings can be substantial.

Valuation[48]

Valuation is as much an art as a science, and if the estate contains substantial hard-to-value assets, the charity should satisfy itself that the executor is being diligent in valuing them. Especially when the charity is the residual beneficiary, executors might be tempted to use less costly but less accurate appraisals since the value would not affect any estate taxes, and the IRS has no incentive to challenge the valuations. If only a portion of the residuary is going to charity there may be a conflict between the recipients with one desiring a higher appraisal and the other a lower one. If the estate will be subject to state or federal estate taxes, the heirs would generally prefer a lower appraisal. Applying common sense here is essential. An "appraisal" done on a real estate valuation website might be perfectly appropriate for a vacation condo unit where there are many similar units, or using various websites to value general personal property.[49] But if an interest in a closely held business is included in the estate, and the interest is to be sold to a related party, a more in-depth and perhaps more costly appraisal may be required. Valuation and net realizable value can also be affected by any shareholders' agreements. Such agreements are common in closely held companies, and may give either the shareholders or the company the right, or the obligation, to purchase the stock. Many, but not all, agreements also set the price at which the sale may, or must, be made. If the agreement allows the purchaser to buy the stock at less than fair market value, there may be estate tax consequences to that agreement. Those issues are discussed below.

Volatility

Are there assets in the estate that carry a larger than average risk of loss in value during administration? To reduce the risk from volatility, it is common for professional fiduciaries to sell them immediately and put the proceeds in an insured or extremely safe account such as a bank CD or a money market account (this may not be practical if the charity is not the full residual beneficiary, as other beneficiaries may not have the same philosophy). Cars, planes, and boats depreciate quickly, generally produce no income, and can be costly to insure and maintain. In some situations, a quick sale at a lower than "market" price may be better than holding out for a higher price, but absorbing the carrying costs and the risks of loss. If the estate includes a closely held business and the decedent was the key person, the business value may evaporate quickly.[50] If the decedent traded in complex financial instruments, gaining an understanding of the estate's financial positions and if they should be unwound promptly is important to both the executor and the charity. Decedent's personal property should be inventoried as soon as possible, and compared to his or her insurance listings. In most situations, it will be prudent for the executor to obtain a third party appraisal of the decedent's personal property. If the charity is sharing the residue, perhaps such items can be allocated to the family share, with the charity taking more of the other assets (assuming the executor has that discretion under the will—otherwise, a settlement agreement may be required). If the charity has the full residue, and the decedent didn't leave specific bequests of these items to family members, the charity should consider encouraging the executor to sell those items to the family promptly at an appropriately fair price. If the family is not interested, prompt disposition of tangible personal property is in order, through live or on-line auctions, consignment, or a local company specializing in estate sales. Obviously, if the estate includes valuable art or collectibles, an expert appraisal and disposition through an auction house is recommended. Since some types of auctions occur only seasonally, there may be storage and insurance

[45] §512(e).

[46] §514.

[47] §511, §515, generally.

[48] Kelley, 830 T.M., *Valuation: General and Real Estate*.

[49] Ebay.com or craigslist.com for personal property; kbb.com for vehicles; alibris.com for books.

[50] Bekerman, 804 T.M., *Probate and Administration of Decedent's Estates*.

ISSN 0886-3547

costs, but those are generally worthwhile for such valuable items.[51]

Lines of Communication Between the Executor and the Charity

Later meetings can be effectively managed by phone, but the initial meeting is key to setting the tone of the estate administration, and should always occur in person, if possible. This initial meeting is also the perfect opportunity to express gratitude for the bequest — after all, the family members in attendance might have otherwise received those funds. The charity should keep the lines of communication open with the executor — asking about progress in the administration process, and checking what information the executor might need from the charity. Regularly scheduled meetings help keep the administration moving, especially if the executor is a family member who is assuming this responsibility in addition to their family and business duties. The executor owes a fiduciary duty to the charity as a beneficiary, but it's in the best interest of all parties to keep the process as collegial as possible.

Beneficiary Designations

As part of the initial meeting, the charity should also inquire about any beneficiary designations. Unlike estate assets, there are less likely to be any administrative or tax impediments to an immediate payment of assets directed to the charity through a beneficiary designation. Also, there is less likely to be hard-to-administer or hard-to-value assets in IRAs, qualified plans, or life insurance contracts, which are the most typical contracts with beneficiary designations.

If the decedent was a beneficiary of a CRT that terminates at his or her death, the CRT trustee has a duty to contact the charity as well,[52] wind up the trust and transfer the remaining assets to the charity. If the decedent left a surviving spouse, often the spouse is a successor beneficiary, so not every CRT will terminate at the death of the first spouse to die. In many CRTs, the settlor of the trust retains the right to change the charity during their lifetime or through their will. If that provision was included in a CRT, the decedent's death causes the charitable remainder beneficiary to become irrevocable, so the charity may now have rights under the document and state law regarding the administration of the trust. Especially if the trustee of the CRT is a family member without experience as a trustee, he or she might be gently encouraged to retain appropriate professional guidance for investment management, valuation, tax, and legal matters of the trust. Where the trustee is a bank or other corporate fiduciary, the charity should carefully check the amounts being charged to wind up the trust and make final distributions. If the CRT was created with a predecessor bank or fiduciary the contract, which the bank or fiduciary inherited may not have provided any additional fees for these tasks.

There may be tax issues if the bequest is a split-interest gift that is not the standard form of a CRT, CGA, CLT (charitable lead trust), or remainder interest in a home or farm.[53] For example, a trust that pays income to the decedent's sister for life, followed by the transfer of the remainder to charity is not deductible, but a CRT for her benefit would allow an estate tax charitable deduction for the value of the remainder interest. Only split interest bequests in those listed formats are deductible for federal estate tax purposes. If a non-deductible split interest bequest is included in the will or trust, and federal taxes may therefore decrease the amount passing to the charity, the charity should consult counsel immediately to see if the bequest can be reformed to obtain the estate tax charitable deduction. Reformation proceedings may be costly, especially if it is necessary to obtain a Private Letter Ruling from the IRS. However, if the tax to be saved is substantial, the cost in time and dollars will probably be worthwhile.

Taxes and Other Administration Issues

As mentioned above, the estate settlement process can be daunting, especially if the executor is inexperienced. As a preliminary matter, the charity should obtain a copy of the inventory and valuation list, which will give the charity a better idea of exactly what property it is entitled to, especially if it is a residuary beneficiary.[54] Often the inability or reluctance of the executor or his or her attorney to supply a proper inventory and valuations within the first six months after the death of the decedent is the first indication of problems. If this situation persists, local counsel may be necessary to prompt the fiduciaries into action. The charity should work with the executor, if at all possible, to ensure it receives the full amount to which it is entitled. Gifts of specified dollar amounts, percentages, or residue can have some

[51] Value, like beauty, is in the eye of the beholder. An executor will balance the cost of storage and insurance with the additional value that could be obtained by waiting for an auction.

[52] Boedecker, above n. 41.

[53] Midura, above n. 10, at 11-8 to -9.

[54] O'Carroll, above n. 37, at 16.

ISSN 0886-3547

effect on other beneficiaries, based on where in the estate the property in question is drawn from.[55]

Often, receiving the full amount the charity was bequeathed means delving into complex tax regulations. One example is ensuring that the executor takes deductions for both income actually distributed and reserved for future distribution to the charity.[56] However, to qualify for these deductions, the amount distributed or reserved must be from "gross income pursuant to the terms of the will (or trust)."[57] If the charity is a partial or full residuary beneficiary, it would be prudent to ask the executor for an opportunity to review the estate's income tax filing (Form 1041 and related state returns) while the returns are still in draft form. (The executor may or may not agree to this.) If the estate is reporting net income on the return, typically there will be a "charitable set-aside" allowed to the estate for the estate's income that will eventually be distributed to the charity. If the charity is a full residuary beneficiary, this set-aside may reduce the taxable income to zero, thus preserving more assets for the eventual distribution. If the charity is to receive less than all of the residue, a partial set-aside should be expected. Due to the complexities of the fiduciary income tax rules and the Alternative Minimum Tax, the charitable income tax deduction may not completely offset the income, especially in the initial year of the estate. If the return is being prepared by a family accountant who may have little experience in fiduciary income taxation and the charitable set-aside, the set-aside deduction may be overlooked or miscalculated. If the executor is reluctant to share the returns in draft form before they are filed, it is still worth requesting copies of the returns as filed, either from the fiduciary or even from the IRS.[58] If, after review, there appears to have been tax paid in error, the returns can be amended.

If the charitable transfer is made via a beneficiary designation, any related income will generally not appear on the estate's fiduciary income tax return. For example, if the decedent named the charity as the beneficiary of his or her IRA, neither the income nor the offsetting deduction would appear on the income tax return (both will appear only on the estate tax return). However, if the decedent had named his or her estate as the beneficiary of the IRA, and then made a specific bequest of the IRA to the charity in the estate documents, both the income and a completely offsetting income tax deduction should appear on the return.[59] For tax and administrative efficiency, the direct beneficiary designation is preferable, and should be encouraged if possible during the planning process.

Note: If the charitable bequest is a pecuniary bequest or a bequest of a specific asset, rather than a share of the residual estate, there will not be an income tax deduction allowed on the estate's income tax return.[60] If state law or the document allocates income from a specific asset to the charity, then there would be a deduction, but only for the amount of income.

Estate taxes are also a concern. This happens primarily when the charity is a residuary beneficiary, but the will directs that estate taxes be paid from that same residuary interest — creating a circular calculation (albeit one whose final result can be calculated in most spreadsheet software or estate planning software) where the tax reduces the charitable deduction, which increases the tax, etc.[61] If this is the case, the charity should investigate whether state law might exempt the charitable bequest from paying estate taxes through the state tax apportionment statutes.[62] Sometimes is it clear from the documents that the testator intended for the charity to share the burden of the taxes; typically the document provisions will override the default state law provisions.[63] Charitable gifts can be reduced by administration expenses as well, either by virtue of the donor's directions, or by equitable apportionment according to state and federal law.[64]

Unexpected increases in estate taxes can occur in many situations, but most of them involve closely held business interests. The first potentially problematic situation involves buy-sell agreements. Many buy-sell agreements allow related parties, or the company itself, to purchase the decedent's interest in the company for less than full fair market value. In accordance with the Treasury Regulations,[65] many of these agreements are not binding for tax valuation purposes, although they are still binding for legal purposes. A charitable estate tax deduction is only allowed for the amount actually passing to the charity. If a business is valued at $20 million, but the family can buy it for $14 million, then the maximum possible charitable deduction allowed would be the $14 million that the estate would receive, thus leaving a $6 million taxable

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[55] Midura, above n. 10, at 11-8. Pennell, 834 T.M., *Transfer Tax Payment and Apportionment*.

[56] Katzenstein, above n. 30, at 1.

[57] Midura, above n. 10, at 11-26.

[58] §6103(e)(1)(E), §6103(e)(1)(F).

[59] §642(c).

[60] *Crestar Bank v. IRS*, 47 F. Supp. 2d 670 (E.D. Va. 1999).

[61] Katzenstein, above n. 30, at 5–8.

[62] *Id.* at 8–11. Pennell, 834 T.M., *Transfer Tax Payment and Apportionment*.

[63] Bekerman, 804 T.M., *Probate and Administration of Decedent's Estates*.

[64] Midura, above n. 10, at 11–22. Beckwith and Allan, 839 T.M., *Estate and Gift Tax Charitable Deductions*.

[65] Reg. §25.2703-1.

ISSN 0886-3547

difference between the value reported on the estate tax return and the charitable deduction allowed (assuming a bequest of 100% of the estate to charity). Even assuming the maximum $5 million[66] estate tax exemption, there would still be a $1 million taxable estate generating a tax of $400,000. That $400,000 would further reduce the charitable bequest of $14 million, thus triggering the circular calculation discussed above.

The second possible problem with closely held business interests involves valuation discounts. Assume the estate includes an 80% interest in a business, with half of that bequeathed to the U.S. citizen surviving spouse and half to a charity. You would assume that there would be no estate tax, given the availability of the marital and charitable estate tax deductions. Unfortunately, the math does not work out as expected. An 80% interest in a closely held business is subject to a valuation discount for lack of marketability, simply because the business is closely held. But the spouse and the charity each receive a 40% interest in the business. Each 40% is subject to a minority interest discount in addition to the estate-level discount for lack of marketability. This is an example of the whole being more than the sum of the parts. Assuming an additional 10% discount for a minority interest, the two 40% deductible bequests only add up to 72% of the estate, thus leaving 8% taxable (and also subject to that circular calculation problem).[67]

No matter what the charity's interest is in the estate, the charity will want to know when the federal estate tax return is filed. The executor may be waiting for the federal closing letter before distributing estate assets. In a wholly charitable estate, the closing letter may be received fairly quickly after the return is filed ("fairly quickly" means three to six months). Unless the estate cannot settle its tax issues through the audit and appeals process and ends up in Tax Court, the closing letter should be received within three years of the filing of the Form 706 estate tax return. If there are state estate tax returns, those may have different deadlines and different administrative processes.

Non-tax administrative issues exist as well. For example, there can be complications involving the payment of interest on a delayed legacy when there are delays in funding testamentary trusts, including CRTs and CLTs.[68]

A final note should be made on the split-interest gift. The value of the charity's remainder interest will be deducted from the taxable estate, but the value of assets allocated to income beneficiaries will not be (unless the sole lifetime beneficiary is the donor's U.S. citizen spouse).[69] CRTs and CGAs are examples of such a gift, although they can also take the form of property interests such as a remainder interest in a home or a farm.[70] In the case of such a remainder interest gift, the charity should strongly consider entering into an agreement with the life tenant spelling out the rights and responsibilities of both parties. Such an agreement will address such matters as insurance, the definition of "repairs" versus "improvements," and who is responsible for paying for them. The agreement should also discuss disposition of the property before the end of the life term. This is especially important if the life tenant is a surviving spouse who may need to sell the property at some point to move to a warmer climate or an assisted living facility. Typically, the proceeds of the sale will be allocated based on the actuarial life expectancy of the life tenant, but an agreement should be reached regarding which life tables are to be used, since state and federal tables may differ. The time to reach this agreement is during the estate administration period — not when the septic tank needs to be replaced or the condo association board issues a special assessment.

Regardless of the form of the gift, the charity with the remainder interest should make sure that it stays in touch with both the lifetime beneficiary and whoever is responsible for care of the assets (the trustee in the case of CRTs). This is because the caretaker has responsibilities (typically codified under state law in the case of trusts) to both beneficiaries.[71] This means the charity should again take care to ensure it is receiving the full amount to which it is entitled.

POTENTIAL PITFALLS

This section aims to outline a number of possible mistakes a charity might make in navigating the estate settlement process.

Failure to Communicate With the Donor's Advisors

Although the charity may have a good understanding of what and how the donor wants to give, the do-

[66] This example does not take into consideration the inflation adjustments since 2012. The inflation-adjusted basic exclusion amount is $5,430,000 for decedents dying and gifts made in 2015. Rev. Proc. 2014-61, 2014-47 I.R.B. 860, §3.33.

[67] *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981).

[68] Katzenstein, above n. 30, at 4–5.

[69] Michael V. Bourland & Jeffrey N. Myers, *The Charitable Remainder Trust*, Planned Giving Design Center (Aug. 17, 1999), *available at* http://www.pgdc.com/pgdc/charitable-remainder-trust.

[70] *Charitable Bequests and Different Aspects of Testamentary Giving*, Indiana University Foundation (2012), *available at* https://options.iuf.indiana.edu/node/21.

[71] Paul L. Comstock, *Investment Strategies for Fiduciaries of Split-Interest Trusts*, Planned Giving Design Center (Dec. 4, 1998), *available at* http://www.pgdc.com/pgdc/investment-strategies-fiduciaries-split-interest-trusts.

ISSN 0886-3547

nor's professional advisors may have no idea. This can cause countless problems during the settlement process, all because the advisors were not apprised of what the donor and charity had discussed and what commitments the donor had made. There is "little doubt that candor will greatly benefit the long-term health of every nonprofit organization."[72]

Failure to Account for Reactions of Surviving Family

Similar to the point above, charities should keep the other beneficiaries, if any, in mind. In a worst case scenario, the donor's family members might be bitter or resentful due to being "passed over" in favor of the charity — which could even lead to litigation. And when there are split-interest gifts, the charity and lifetime beneficiary will likely be tied together by the assets until all the remaining non-charitable interests have expired. Maintaining good relationships with the donor's family during all phases of the process is essential, and can aid the flow of information to the charity.

Failure to Have Gift-Acceptance Guidelines in Place

The charity receives surprise notice that it has been bequeathed the mineral rights to a patch of land. This sounds great — but what if the charity has no experience with such gifts? How should it know if the cost is worth the benefit? What about potential environmental liability risks? How would the charity go about liquidating the asset? It is important to have policies for evaluating which gifts to accept, particularly when it comes to nontraditional gifts.[73] Any time environmental risks are a concern, both state law and any relevant documents should be reviewed to see if they provide any additional protection.

Failure to Follow Proper Tax and Accounting Procedures

As described in earlier sections. These problems can range from wrongful payment of income or estate taxes from the assets bequeathed to charity, to the charity recognizing receipt of the gift in the wrong period (or in the wrong amount). These are problems which can start small, by simply neglecting to fill out or obtain paperwork, but can end up costing the charity real money by adding to the tax or administrative costs to the estate.

Failure to Thank Surviving Family

This can be easy to forget — once the settlement process is over (or the charity has received its remainder interest), its formal involvement with the donor's estate is over. But an appropriate token of appreciation can go a long way, and "ongoing stewardship of surviving family members can result in tremendous long-term benefits for your organization."[74] Not only can the surviving family potentially become donors, but a show of gratitude can go a long way towards building strong relationships with the community.

Failure to Comply With Regulatory Rules

Aside from maintaining 501(c)(3) status under federal law, there are also state compliance issues. The charity will in all likelihood already be registered with at least one state office, but there may be additional registration requirements relating to estate settlement. For example, Illinois requires that all estates and trusts holding assets for charity over $4,000 be registered — this can lead to potential headaches when working with inexperienced executors.[75] If the estate establishes a charitable gift annuity (an admittedly rare occurrence), the charity must be sure it is registered in all relevant states.

Failure to Accurately Tailor Restrictions on the Gift

Restrictions on the gift in the governing document — typically relating to use of the gift — can cause problems for both the charity and the estate. For example, if the donor earmarks the gift "for a noncharitable purpose, or even a charitable purpose that is outside of the donee organization's charitable mission, the gift is not deductible."[76] From the charity's perspective, it might lose the gift entirely if it does not comply with conditions, if there is a reverter clause or

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[72] Livingston, above n. 33, at 8.

[73] See Hancock, above n. 26, at 6–8 (describing gift acceptance considerations for gifts relating to mineral interests); *Managing Nontraditional Donations*, KeyBank, *available at* https://www.key.com/business/programs/managing_nontraditional_donations.jsp (describing potential maintenance, insurance, appraisal, and liquidation concerns for nontraditional donations).

[74] Dawn Myers Slawson, *After the Bequest — Estate Administration Tips*, Sharpe Group (July 1, 2006), *available at* http://sharpenet.com/give-take/bequest-estate-administration-tips/.

[75] Midura, above n. 10, at 11–28, citing 760 ILCS 55/2, 55/5, 55/6.

[76] Alan F. Rothschild Jr., *Planning & Documenting Charitable Gifts*, A.B.A. (2007), *available at* https://www.americanbar.org/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/planningcharitablegifts.html.

ISSN 0886-3547

a "gift over" clause that would transfer the property to another charity.[77] Hence, there should be careful planning when restrictions are involved, and both the estate and the charity should keep those restrictions in mind when it comes to distribution and use of the gift.[78]

Potential Conflicts of Interest

The final potential issue is one of professional ethics. Professional advisors must take care not to represent both parties in the process, which would constitute a conflict of interest.[79] This can happen, for example, when a potential donor's attorney is also on the charity's board — although it may seem convenient to all parties involved, it is nonetheless an ethics violation. The charity must ensure that its representation is independent of the donor and estate.

[77] *Id.*

[78] Susan N. Gary, *The Problems with Donor Intent: Interpretation, Enforcement, and Doing the Right Thing*, 85 Chi.-Kent L. Rev. 977 (2010).

[79] *Id.*

CONCLUSION

This article has discussed estate settlement for charities, from the groundwork laid during the planning process through final distribution of the gift. It discussed the practical and legal implications of various forms of gifts, and recommended steps to take to ensure the process goes smoothly. It also highlighted various issues that might arise if the parties involved do not take proper care. Leaving a bequest to charity is a wonderful way to support countless worthy causes, and, even though it can be a daunting and complex process, everyone with the means to do so should consider it. But charities and their advisors have a responsibility to effectively navigate the estate settlement process, so that the charitable gift and its impact can be maximized.