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Why do we care about section 457A?

- Section 457A effectively eliminated the ability to defer management fees and carried interests (if the carry represents a right to compensation) in offshore funds organized in low tax jurisdictions.
- Billions of dollars must be recognized by effected taxpayers within the next 24 months.
- Clients facing this income recognition can jumpstart or enhance their philanthropic legacies as a way to offset some of the income tax liability they will otherwise face

Who is Affected by section 457A?

- Any person who received deferred compensation under a nonqualified plan of a nonqualified entity attributable to services performed prior to January 1, 2009 and who has not yet recognized that compensation in their gross income.
  - Nonqualified entity = any foreign corporation unless substantially all of its income is effectively connected with the conduct of trade or business in the U.S. or is subject to a comprehensive foreign income tax or any partnership unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive income tax and organizations which are exempt from U.S. tax
  - Nonqualified deferred compensation plan = that term as defined in section 409A(d) except it shall also include any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units in the service recipient.

Overview of History of 457A - Pre-2004

- Prior to 2004, recognition of nonqualified deferred compensation was determined on a facts and circumstances basis under I.R.C. sections 83 (relating to transfers of property in connection with performance of services) and section 451 (constructive receipt)
- Structures such as Rabbi Trusts could be used to defer income recognition while providing employees with security their vested compensation was relatively safe and within their control

Overview of History of 457A - Post 2004

- Section 409A was enacted in 2004 to provide specific rules to govern nonqualified deferred compensation structures
- 409A provides that all amounts deferred under a nonqualified deferred compensation plan are includible in the gross income of a service provider unless the plan meets certain requirements including restrictions on distributions from the plan

Overview of History of 457A - Post 2004

- Special statutory rules also exist with regard to the timing of the deductions taken by service recipients for the compensation paid to the service providers. Generally the recipients can only take a deduction in the same year the provider recognizes the income.
- For nonqualified deferred compensation plans, this means the tension between the service recipient wanting the deduction and the service provider wanting to defer income recognition works a balance between how much compensation the service recipient is willing to allow the service provider to defer in such a plan. And this tension means the cost of the deferral is born by the service recipient

Overview of History of 457A - 409A's Loophole

- After the enactment of section 409A, a loophole remained for structures where the tension between the timing of service recipient's deduction and the service provider's recognition did not exist - namely when the service recipient was a foreign corporation or partnership not subject to comprehensive U.S. or foreign income taxation ("nonqualified entities").
- 457A was enacted to apply additional rules to nonqualified deferred compensation plans of nonqualified entities so that the compensation must be recognized when there is no substantial risk of forfeiture of the service provider's rights to the compensation

457A Closes the Loophole

- Under 457A, compensation is subject to substantial risk of forfeiture only if the right to the compensation is conditioned upon the future performance of substantial services by any person.
- Compensation attributable to services performed after December 31, 2008 is subject to section 457A
- Compensation attributable to services performed prior to January 1, 2009 must be included in the income of the service provider no later than the last taxable year beginning before 2018 or the taxable year in which there is no substantial risk of forfeiture, if later.

So what does 457A have to do with FCCF?

- Billions of Dollars in deferred compensation which was grandfathered by 457A must be recognized before January 1, 2018
- Charitable Deductions can be an attractive method for reducing the income tax bills this recognition will generate for effected service providers.
- Many affected taxpayers have not had time to focus on their philanthropic goals but may be willing to make the time now giving the taxes they are now facing on their deferred compensation.

Tax Incentives For Charitable Giving

- Federal tax code encourages charitable giving
  - income tax deduction (limited)
  - estate tax deduction (unlimited)
  - gift tax deduction (unlimited)
- Tax incentives more favorable for
  - lifetime gifts than gifts at death
  - gifts of appreciated property than gifts of cash
  - gifts to *public charities* than to *private foundations*
    - Gifts to public charities and private operating foundations deductible up to 50 percent of adjusted gross income computed without regard to net operating loss carrybacks.
    - Gifts to most private foundations deductible up to 30 percent of adjusted gross income computed without regard to net operating loss carrybacks.

Types Of Charities

- Public charities
  - traditional, e.g., churches, schools, colleges, hospitals
  - community foundations
  - supporting organizations
  - donor-advised funds
  - private operating foundations

- Private foundations
  - family
  - corporate

The Types Of Charitable Giving

Types of charitable gifts

- direct gifts
  - directly to public charities
  - to donor advised funds
  - to private foundations

- split-interest charitable gifts
  - lead gifts
  - remainder gifts

Charitable Gift Annuity

- Donor gifts assets to a charity in exchange for a promise from the charity to pay donor a fixed sum for life
- This transaction is part charitable gift and part purchase of an annuity
- Generally, the difference between the actual value of the annuity received and the value of the sum donated is a gift to the charity

Benefits Of A Charitable Gift Annuity

- A current gift to charity
- A significant charitable income tax deduction
- A reliable fixed stream of income for life
- Potential capital gains tax savings
- Estate tax savings

Charitable Lead Trust

- Client contributes appreciating assets to a trust
- A charity receives a fixed annuity (CLAT) or a changing unitrust amount (CLUT) for term of years
- Options for charitable beneficiary:
  - Designate specific 501(c)(3) charity or charities such as Fairfield County's Community Foundation and amount/percentage to charities in CLAT/CLUT
  - Provide Trustee with discretion to determine 501(c)(3) charities and/or amounts to charities
    - If Trustee has discretion to select a 501(c)(3) charity that is not a publicly supported charity (e.g., a private foundation), then the Trustee will be required to submit additional documentation to the IRS on such annuity/unitrust payments
- Remainder paid to family members at end of term

Advantages and Disadvantages Of Charitable Lead Trust

- Advantages
  - income taxed to trust and deductible to extent paid to charity
  - may reduce gift and estate taxes
  - support charity
  - income tax deduction for charitable contributions from a grantor CLT in the year CLT is established
- Disadvantages
  - donor and family members will not have access to the trust income nor the principal while the trust is in existence
  - Gifts to CLTs do not qualify for the annual gift exclusion
  - No income tax deduction for charitable contributions from a non-grantor CLT

Charitable Lead Annuity Trust Example

- Assumptions
  - Sam gifts $2 million of stock to CLAT
  - IRS assumed interest rate is 2.2%
  - Trust investments grow at 8% per year
  - Sam provides for annual payout of $100,000 to Charity for 17 years
- No income tax deduction for donor (income taxed to non-grantor CLAT)
- Charity receives $1,700,000 in annuity payments over 17 years
- Sam's children receive $4,025,013.55 at end of 17 years
- Client pays *zero gift or estate tax* on transfer to family

Charitable Remainder Trust

- Donor contributes assets to trust
- Fixed annuity (“CRAT”) or changing unitrust amount paid to donor (and spouse/others) for life (“CRUT”)
- Remainder paid to charity upon death

CRAT vs. CRUT

- CRAT:
  - Fixed Payments
  - Charity Bears Entire Market Risk
  - Grantor Bears Inflation Risk
  - No Additional Contributions Allowed
  - Most Appropriate for Older Grantors
- CRUT:
  - Variable Payments
  - Market Risk Shared By Income Beneficiary and Charity
  - Hedge Against Inflation
  - Additional Contributions Permitted

Benefits Of A Charitable Remainder Trust

- Benefits of Charitable Remainder Trust
  - support charity
  - may increase cash flow
  - defer capital gains on appreciated assets
  - obtain income tax deduction
  - charitable remainder beneficiary may be changed during term of the trust

Charitable Remainder Unitrust Example

- Sam, age 65, wants to benefit Fairfield County's Community Foundation
  - gives $100,000 of stock to CRUT in February 2016
  - reserves 5% unitrust payment annually for life
  - lives for 17 years
  - IRS assumed interest rate for February 2016 is 2.2%
  - trust total return is 7.5% per year
- Sam receives
  - charitable income tax deduction of $34,041 for 2016
  - $186,619 in unitrust payments over 17 years
  - ability to diversify investments income tax-free
- Fairfield County's Community Foundation receives $242,817 upon Sam's death

Private Family Foundation

- Greatest donor control
- 3 typical characteristics:
  - single source of funding
  - make grants rather than operate programs
  - grants and administrative expenses paid from endowment
- 5% mandatory annual distributions
- Annual Reporting to IRS and in some states to attorney general

Donor Advised Funds

- Simple method to create a family charitable legacy
- Created either through a Community Foundation (e.g., Fairfield County's Community Foundation) or Financial Institution
- Treated as a donation to a public charity
- Family relieved of annual reporting responsibilities
- Family provides <u>guidance</u> on annual distributions

Comparison Of Charitable Gifting Strategies

Objective	Outright Gift	Private Foundation	Donor Advised Fund	Charitable Remainder Trust	Charitable Gift Annuity	Charitable Lead Trust	Bequest at Death
Avoid Capital Gains	Yes	Yes	Yes	Yes(4)	Yes	Yes	N/A
Get Charitable Deduction	Yes	Yes	Yes	Yes	Yes	No(1)	Yes(3)
Promote Charitable Goals	Now	Now	Now	Future	Now	Now	Future
Retain Future Control	No	Yes	Almost	Yes	No	Yes	Yes
Timing of Benefit to Charity	Now	Ongoing	Ongoing	Later	Now	Ongoing	Later
Financial Benefit to Family	No(2)	No(2)	No(2)	Now	Now	Later	No

(1) Practical result is to obtain the benefit of a deduction due to shifting of taxable income

(2) Except to the extent of relieving family of ongoing philanthropic commitments

(3) Estate tax deduction, but no income tax deduction

(4) Capital gains are deferred

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