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# Tis the Season for Charitable Gift Planning

*While charitable giving has always been an important part of tax planning, the current tax and economic environment has greatly incentivized many wealthy individuals to give more.*

Higher tax rates and a concentration of asset growth from both an appreciation and overall net-worth standpoint have created optimum conditions for giving. Charitable planning not only serves to reduce taxes, but also can alleviate concerns of too much wealth going to heirs. Not surprisingly, charitable giving has been up significantly in recent years. Given these realities, there exists a need for integrated charitable planning, both in the short-term and long-term, in order to maximize efficiencies for both income and transfer tax savings.

The simplest form of giving is an outright gift to charity, which provides for a current year tax deduction. However, it is important to know the rules so that the expected result is achieved. Charitable deductions can be limited depending on what type of property is contributed, the type of organization donated to and the taxpayer's adjusted gross income (AGI). A cash gift to a public charity (including a donor advised fund) generates a deduction up to 50% of the taxpayer's AGI (30% for contributions to private foundations), while a contribution of appreciated assets

generates a deduction up to 30% of AGI (20% for contributions to a private foundation). Any portion of the contribution that is not deductible due to these limitations in the current year carries over for five years.

Along with these AGI limitations, taxpayers must also be cognizant of whether their deduction base is fair market value or basis, which is also dependent on the asset and organization. When giving to public charities or donor advised funds, assets held long-term (held more than 12 months) will qualify as fair market value property. If giving to a private foundation, only long-term stock trading on an established market would qualify. As assets get more complicated (tangible, ordinary income property, etc.), so too do the rules establishing the deduction base.

Finally, when making outright contributions, taxpayers should be sure to follow IRS requirements to insure deductions are allowed. For example, depending on what and how much is contributed, an appraisal may need to be prepared and filed with the tax return to substantiate the deduction. While outright giving is an easy way to accomplish charitable goals on a yearly basis, for more complex situations, other charitable planning techniques can provide greater efficiencies.

For individuals looking to diversify a highly appreciated, concentrated position, a charitable remainder trust (CRT) can be a very attractive option. This type of trust allows for an immediate charitable deduction and gain deferral, while still providing the donor and/or donor's spouse a controlled income stream until the trust terminates and the remainder goes to a charity (including a foundation) of the donor's choosing. Depending on the specific fact pattern, CRTs can be tailored to an individual's specific tax and non-tax needs.

For taxpayers looking to achieve both income and transfer tax benefits, a charitable lead trust (CLT) can be a very powerful tool. Essentially the opposite of the CRT, a CLT provides for a fixed annual income stream to a charity (also including a foundation) of the donor's choosing, with the remainder going to heirs. From a gift tax perspective, the trust can be structured so that the present value of the remainder interest is worth zero, thereby avoiding any gift tax issues. To the extent the trust assets outperform the proscribed interest rate used to determine the present-value of the remainder interest (2% in November), that appreciation passes to heirs free of transfer tax.

From an income tax perspective, a CLT can be either a grantor or a non-grantor trust. If structured as a grantor trust, the donor gets an immediate charitable deduction, typically equal to 100% of the value transferred to the trust, and then pays the trust's income tax bill until termination. If structured as a non-grantor trust, the donor does not get a charitable deduction for the gift. Instead, income that would have been taxed on the donor's individual income tax return attributable to the assets transferred is moved to the trust's income tax return, where it is typically off-set by the trust's charitable deduction as it makes annual payments to charity. Like a CRT, a CLT can be tailored to fit a specific situation. In addition to the CLT itself, it is also possible to engineer financial instruments to maximize CLT efficiencies as well.

In today's tax and economic environment, charitable giving can be highly effective. From simple outright contributions to very sophisticated planning, charitable giving can take many forms and provide several benefits. To meet both tax and non-tax objectives, proper planning is critical and should be viewed with short and long-term goals in mind.

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# Considerations for Tax-Exempt Organizations Investing in Pass-Through Entities

*With assets totaling several trillion dollars, tax-exempt organizations in the United States are a significant segment of investors in financial markets.*

Some tax-exempt organizations, such as university endowments, foundations, and qualified pension funds, have reported record donations and holdings during 2015. With the strong market performance of recent years and the low interest rate environment, many tax-exempt organizations have become incentivized to enter into alternative investments, such as hedge and private equity funds.

Lurking beneath the allure of higher investment returns, however, are special tax considerations of which tax-exempt organizations should be mindful when making those alternative investments. While the structure of these funds can take many forms, they are typically formed as limited partnerships or limited liability companies taxed as partnerships. For tax purposes, income from these funds is treated as passing through, and being taxed directly, to the investors in the fund. As a consequence of this attribute, tax-exempt organizations may unknowingly be subject to tax on certain investment returns and attendant filing requirements under federal and state law.

Aside from the excise tax on a private foundation's net investment income, tax-exempt organizations are generally not subject to tax on income derived from activities that are related to their exempt purpose. Conversely, business income from activities that are unrelated to the organization's exempt purpose may be taxable to the extent it exceeds allowable deductions from those unrelated business activities. This taxable amount is referred to as unrelated business taxable income (UBTI). Exempt organizations with UBTI are generally required to file Form 990-T, Exempt Organization Business Income Tax Return, with IRS. This is an additional requirement for organizations that already file returns with IRS (i.e., Form 990, Form 990-PF, or Form 5500, et al). The tax rate that applies to UBTI depends on the legal form of the tax-exempt organization under state law. Trusts are subject to the graduated rates for trusts, whereas corporations are subject to the corporate income tax rates. Tax-exempt entities with UBTI are also subject to the alternative minimum tax rules.

UBTI generally does not include investment income, such as interest, dividends, rents, royalties, and capital gains, but there are other factors to consider that may cause such types of income to fall under the UBTI designation. If, for example, a tax-exempt organization borrows money to acquire property, a proportional amount of the income from such property attributable to the debt-financing is includable in the definition of UBTI. To illustrate this concept, suppose a tax-exempt organization with $50 and no other assets borrows $50 to acquire an investment for $100. Under this fact pattern, 50% of the income from that investment, the debt-financed portion, will be subject to taxation despite the general exclusion of investment income from UBTI.

As a partner in a partnership, an exempt organization will include in UBTI its share of partnerships income that would be considered UBTI if it were earned directly by the exempt organization. To illustrate, suppose an exempt organization provides 50% of the capital requirement for a private equity venture taxed as a partnership for federal income tax purposes. The private equity fund invests in other partnerships engaged in trades or businesses that, if owned directly by the exempt organization, would be considered unrelated trades or businesses. If the private equity fund received $100 of business income from its underlying investments, the exempt organization would include $50 in UBTI with respect to that private equity investment. This result is the same whether the exempt organization is a general or limited partner in the venture.

Similar to individual taxpayers, certain tax-exempt organizations are subject to limitations on losses from passive activities. The loss limitations apply to items that may be included in UBTI. Generally, losses from passive activities may only be used to offset income from passive activities. Losses that exceed passive activity income are carried forward and can be utilized to offset passive activity income generated in future years or upon disposition of the activity generating the income or loss. As a result, an activity may appear to be generating losses but, when the limitations are properly applied, the activity is in fact generating income that is taxable as UBTI.

Publicly traded partnerships (PTPs), which include master limited partnerships, present a similar pitfall when they report losses to their investors. Income passed through from these investments will generally fall under the definition of UBTI. To the extent a PTP reports a loss to an investor in the current year, the loss is carried forward to future years. Although they generally follow the same rules as other partnership investments, net losses from PTPs can only offset future income from the same PTP. In contrast, other passive activities subject to the loss limitations described above can be aggregated or separated into groups of activities that are analyzed together to determine whether the limitation applies. Similar to other passive activities, losses from PTPs may be utilized in the year the partner disposes of its interest therein.

Pension trusts, public charities, and private foundations may also be S corporation shareholders. The major tax

characteristic of an S corporation is that the income is treated as passing through, and is taxed annually, to its owners, similar to a partnership. As a general rule, all income from an S corporation is treated as UBTI to a tax-exempt shareholder, except for employee stock ownership plans (ESOPs).

The investment community is aware of UBTI and the effect it might have on returns for tax-exempt organizations or their willingness to participate in alternative investment funds. As a result, the use of *blocker* corporations has become common-place as a way to lessen the impact of UBTI. Since income does not pass through a corporation for tax purposes the way it does a partnership, the corporation blocks the tax-exempt investor from UBTI by participating in the venture and in-turn paying a dividend, which would not be considered UBTI. This structure is not without consequence, however, as corporations are separately subject to income tax on earnings, no matter the source.

State governments are also on the look-out for UBTI. Partners in a partnership will be subject to the tax laws and filing requirements of a particular state if the partnership holds underlying investments in that state. Currently, most states impose some form of tax on UBTI. The treatment of different tax-exempt organizations and the methods for calculating UBTI vary considerably from state to state.

In addition to potential UBTI exposure, tax-exempt organizations may be subject to a host of other filing requirements when investing in alternatives. The following are a few examples of such filings (not an all-inclusive list). Investing in a foreign partnership, or a domestic investment fund that holds an interest in a foreign partnership, may give rise to a requirement to file Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*. Similarly, investing in a foreign corporation or an investment fund that contributes capital to a foreign corporation could give rise to a requirement to file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*, or Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*. Failure to file these forms could result in stiff penalties – in some cases up to $100,000 per form. Furthermore, tax-exempt organizations generally are not subject to the rules related to passive foreign investment companies (PFICs). Income from a PFIC investment, however, could be subject to UBTI under certain circumstances and therefore taxable. In this case, the organization must file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, with respect to its direct or indirect investment in the taxable PFIC.

While the upside of alternative investment funds is attractive to tax-exempt organizations looking for a more competitive return, such organizations should be wary of potential tax consequences and filing requirements that may result when entering into such ventures. Certain types of investment returns that would not otherwise be subject to tax may become taxable. The organization may also face a substantial administrative burden with respect to its new tax filing requirements. Taxes, though, are not the only factor to consider when choosing investments. Alternative investment platforms may provide for greater diversity and be an integral part of an organization's investment strategy. A tax professional with the right experience and expertise can help an organization identify and assist with structuring, avoiding pitfalls and, overall, keeping in compliance with applicable reporting requirements.

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# Income Tax Accounting, Controls, and Consulting Services are High on the PCAOB 2015 Inspections Agenda

*Income taxes continue to be a primary area of focus for the Public Company Accounting Oversight Board (PCAOB).*

This will be reflected in PCAOB inspections of 2015 public company audits, and in PCAOB inspections of the firms performing those audits. Accordingly, public companies should expect audit firms to place more emphasis on income tax matters in upcoming audits.

The PCAOB was organized by Congress through the Sarbanes-Oxley Act of 2002 to oversee the audit firms of public companies. The PCAOB establishes quality control, independence, and other standards relating to public company audits and conducts inspections, investigations, and disciplinary proceedings of the firms conducting those audits.

Of specific importance to tax practitioners and those responsible for income tax reporting, the PCAOB October 2015 Staff Inspection Brief (the *October Brief*) Vol. 2015/2 announced that:

1. Accounting for income taxes will continue to be an area of focus for PCAOB inspections of the registered audit firms and their audits in 2015;
2. Auditing of internal controls over financial reporting (including those related to income taxes) remains a major point of PCAOB concern; and
3. The PCAOB believes that non-audit services provided by audit firms to their audit clients may represent an audit quality risk.

Note that the PCAOB did not specifically identify tax services as a non-audit service provided by audit firms that may impact audit quality. However, given the PCAOB focus on income tax accounting and the frequency with which audit firms continue to provide income tax consulting services to their audit clients, it is reasonable to expect that tax services rendered by audit firms to their audit clients will be an issue garnering regular attention from the PCAOB inspection teams.

## Continued PCAOB scrutiny of public company audits and audit firms

The October Brief reflects the ongoing efforts of the PCAOB to improve the quality of public company financial reporting, financial reporting controls, and the independent audit of public company financial reporting and controls. The Board annually selects for inspection public company annual reports audited by each of the largest audit firms and reports its findings for each audit firm in a two-part inspection report. Audits for which a financial reporting issue (or issues) is not adequately addressed by the audit firm are identified as audit failures in Part I of the inspection reports. Based on data compiled and illustrated in the chart below, PCAOB inspection reports through 2014 of the largest audit firms do not indicate a sustained decrease in the percentage of failures identified in public company audits conducted by those firms.

Failure Rate as a Percentage of Audits Inspected by the PCAOB
(Part I of Inspection Reports)

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| Deloitte | 21% | 46% | 42% | 25% | 29% | 21% |
| EY | 34% | 21% | 36% | 49% | 50% | 36% |
| PWC | 22% | 39% | 43% | 40% | 33% | 30% |
| KPMG | 13% | 23% | 23% | 35% | 48% | 55% |
| McGladrey | N/A | N/A | 50% | 44% | 31% | 47% |
| BDO | N/A | 26% | 39% | 55% | 65% | N/A |
| GT | 36% | 37% | 43% | 65% | 56% | N/A |

Audit firm-level deficiencies are initially reported only to the examined audit firm in Part II of the annual inspection report. If a firm does not demonstrate to the PCAOB sufficient remediation of the root causes of firm-level deficiencies as communicated in Part II of the report, that portion of the report is publicly released. To date, Part II

of 12 inspection reports from prior years for the largest firms have been issued.

## Income taxes reporting an area of focus

According to the October Brief, growing risks in the audit of income tax accounting have led the PCAOB to place additional focus on this area. As an example of these growing risks, the Brief highlights the income tax accounting and disclosures related to operations in foreign jurisdictions, particularly when significant undistributed earnings exist. Indefinite reinvestment assertions related to undistributed foreign earnings are expected to draw significant attention in the 2015 inspection process.

It is anticipated that the issuance by the Organization for Economic Co-operation and Development (OECD) of the Base Erosion and Profit Shifting (BEPS) final report in 2015 will elevate attention by PCAOB to other international aspects of income tax reporting. Scrutiny in the often complex and subjective areas of financial reporting relative to income tax valuation allowances and to uncertain tax positions should also be expected to continue.

## Income taxes and internal controls

The October Brief also states that the PCAOB will be *taking a close look* at the auditing of internal controls over financial reporting in the 2015 inspection cycle. This is one of three general areas (together with material misstatement risk assessment and response, and auditing accounting estimates) where, according the PCAOB, *inspectors found significant deficiencies in the past several years.* Historically, public companies have identified inadequate levels of staffing, training, and oversight as being among the most prevalent issues leading to material weaknesses in income tax-related internal controls.

The Board's interest in internal controls should not be surprising. According to Audit Analytics, more than 80% of public company annual report restatements in 2014 involved companies that had previously reported (without disagreement from their audit firms) that the companies' internal controls were effective. The PCAOB is understandably concerned that material control weaknesses existed, but were not identified, at the time of the initial annual report's issuance.

The PCAOB will expect audit firms to devote more resources into identifying these control weaknesses before they lead to the need for restatements. Future PCAOB inspections will evaluate audit firms' ability to target particular recurring deficiencies so as to improve audit quality.

## Non-audit services provided by auditing firms to their audit clients

In the October Brief, the PCAOB also observed that a number of audit firms have experienced significant growth in their consulting practices. Often, the Brief notes, a firm's consulting services have been provided to audit clients of that firm. The PCAOB's observations and concerns are consistent with reports that the audit firms have experienced a 10% average growth rate of non-audit services in recent years, relative to the modest 4% audit services average growth rate during that timeframe.

According to the PCAOB, shifting the focus to these non-audit services has shown to be a potential distraction away from audit objectives, as firm leaders emphasize promotion of new business over audit quality. In a speech earlier this year, PCAOB board member Steven B. Harris expressed concern that some types of non-audit services create inherent conflicts which can detract from auditor objectivity.

## Action to be taken by public companies now

The PCAOB's continuing focus on income tax issues relative to the audits of public companies will likely lead to greater scrutiny of those issues by the firms auditing those companies. Public companies should examine their policies, procedures, and controls related to income taxes to prepare for this heightened scrutiny. In addition, public companies should continue to carefully monitor the non-audit services provided by their audit firms.