The 23rd Annual

Planned Giving CONFERENCE

presented by the **Northern California Planned Giving Council**

in association with Colonial Consulting, LLC

MASTERS TRACK

Session 3: 2:15 pm - 3:30 pm

Topic:

Tax and Other Considerations in Charitable Remainder Trust Investing

Presented by:

Matthew E. Brady

Workshop Summary:

Structuring investments in a charitable remainder trust requires knowledge of several tax and legal rules, in addition to principles of investing. This workshop will explore the considerations involved in structuring investments in a charitable remainder trust, and examines several case studies which present some of the most challenging issues.

Workshop Presenter

Matthew E. Brady, Senior Vice President and Senior Director of Planning, joined Wells Fargo in 2013 to lead the wealth planning team in California.

Matt began his career at the New York City law firm of Donovan Leisure Newton & Irvine, where he was a partner in the tax department. He became a partner at Coopers & Lybrand in San Francisco, and then a principal at Banc of America Securities, where he worked closely with investment bankers and financial advisors on business transactions and personal wealth issues arising from wealth creation events. Matt also led the family office group at Robertson Stephens, which offered integrated wealth management and investment consultation to high net worth families. Subsequently Matt led the national wealth advisory team at Lehman Brothers and Barclays Capital, and was a member of the board of directors of the Lehman Brothers Trust Company. Immediately before joining Wells Fargo Matt was a managing director at Deutsche Bank, working with high net worth families on wealth management and structuring matters.

He has published a number of articles, including "Estate Planning for Venture Capital Managers," "Build America Bonds", and "Addressing Personal Wealth Considerations in an IPO."

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WELLS FARGO

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Tax (and Other) Considerations in Charitable Split-Interest Trust Investing

Matthew Brady
Senior Director of Planning
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Together we'll go far

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WELLS FARGO

General Considerations and Constraints

Some General Considerations

- Tax law considerations
  - A trust does not qualify as a CRT if the trust instrument prevents the trustee "from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust asset". Treas. Reg. § 1.664-1(a)(3).
    - Some private rulings disqualify CRTs which restrict investments to specific asset classes
      - Revenue Ruling 73-601, 1973-2 C.B. 213 (grantor's spouse had a life estate in antiques collection, preventing the trust from using the assets to produce income)
      - PLR 7802037 (provision requiring the trust to invest only in municipal securities disqualified the trust as a CRT)
  - Private foundation rules applicable to split-interest trusts
    - Self-dealing (§ 4941)
    - Excess business holdings (§ 4943)
    - Jeopardizing investments (§ 4944)
    - Taxable expenditures (§ 4945)

Private Foundation Rules

- Applicability of private foundation rules
  - Section 4947 makes several private foundation excise tax provisions applicable to split-interest trusts
    - Self-dealing (§ 4941)
    - Excess business holdings (§ 4943)
    - Jeopardizing investments (§ 4944)
    - Taxable expenditures (§ 4945)
  - Excess business holdings defined
    - "Permitted holdings" total 20% of a corporation's stock, less the amount held by all disqualified persons, subject to a 2% de minimis rule
    - Parallel provisions for entities in partnership form
    - Special (somewhat more liberal) rules where a third party has control of the enterprise and for preferred stock
  - "Jeopardizing" investments
    - Foundation managers have failed to exercise "ordinary business care and prudence" (Treas. Reg. § 53.4944-1(a)(2))
    - No investment specifically prohibited – each investment judged in the context of the overall portfolio
    - Specific transactions (trading on margin, trading in options and commodities, short selling, natural resource investments) receive close scrutiny

Private Foundation Rules - Exceptions

- Sections 4943 and 4944 do not apply to:
  - Charitable lead trusts (all income interests paid for charitable purposes; none of the remainder) where the value of the charitable income interest is not more than 60% of the total trust value, or
  - Charitable remainder trusts where a charitable deduction is allowable for the remainder interest but none of the income interest
  - Many CRTs will therefore not be subject to the excess business holdings and jeopardizing investment rules (although most portfolios will probably not violate those rules anyway)
  - Zeroed-out CLATs vs. "taxable" CLATs
    - See Baskies & Blattmachr, "Follow-Up on Taxable CLATs: An Oft-Overlooked and Little-Known Exception Makes Them Even More Attractive," Leimberg Services (October 2012)

General Considerations

- Purpose of the trust
  General considerations in planning a portfolio:
  - Time horizon
  - Income needs/distribution planning
  - Risk tolerance/growth expectation
  - Economic considerations
  - Capital market expectations
  - Charitable inclination
  - Funding of the trust
  - Tax considerations
  - And, not to overlook the obvious, fiduciary duty issues of the trustee

Fiduciary Concerns

Prudent Investor Rule

- § 16047
  - A trustee "shall invest and manage trust assets as a prudent investor does". Decisions need to take into account the purpose of the trust, terms, distribution requirements, and other circumstances.
  - Investment decisions are considered not in isolation, but in the context of the trust portfolio as a whole
  - Trust portfolio is a part of an overall investment philosophy having risk and return characteristics reasonably related to the purposes of the trust
    - Focus on risk management in light of the goals of the trust
  - The statute lists a number of specific factors that a trustee may take into consideration, including general economic conditions
  - A trustee may invest in "any kind of property or type of investment" consistent with the standards of the statute
- § 16048 – Diversification
  - Under modern portfolio theory, some (but not all) risk can be eliminated through diversification
    - The market does not reward risk-taking if diversification would eliminate the risk
    - Diversification does not eliminate market risk; it can reduce risk attributable to a single industry or, especially, a company
    - Restatement (Third) of Trusts § 90 cmt.e(1)(2007): "Because market pricing cannot be expected to recognize and reward a particular investor's failure to diversify, a trustee's acceptance of this type of risk cannot, without more, be justified on grounds of enhancing expected return."
  - Under the UPIA (and § 16048 of the Probate Code), a trustee "has a duty to diversify the investments of the trust" unless "it is prudent not to do so"

Prudent Investor Rule

- Issues with diversification
  - How much is enough?
    - Research suggests that holding 20 stocks in a portfolio provides almost all of the advantage of diversification; one treatise comments that "once you have a portfolio of 20 or more stocks, diversification has done the bulk of its work". Brealey, Myers & Allen, Principles of Corporate Finance 174 (11th ed. 2013); see also Sitkoff, "Back to School: A (Re)Introduction to the Law of Trusts)(presented at the 2014 Heckerling Institute)
  - Reasons not to diversify
    - Tax costs
    - Wish to retain a family business
    - Provisions of the trust document
    - In re HSBC Bank USA, NA, 947 N.Y.S.2d 292 (App. Div. 2012) – failure to diversify securities received by gift in trust violated fiduciary duty when the trustee removed the stock from its internal "hold list"; but the trustee did not violate the prudent investor rule by maintaining an "overweight" allocation to some stocks, where the weighting resulted in part from stock distributions and the advice of a knowledgeable advisor recommended retention
    - In re Estate of Saxon, 712 N.Y.S.2d 225 (App. Div. 2000) – failure to diversify IBM shares held by a charitable lead trust was a breach of fiduciary duty when the trustee retained shares, in contravention of internal policy, and never created a plan of diversification (decided under earlier law based on the "prudent person" standard)
- The importance of process
  - Following internal guidelines
  - Regular consideration of the trust portfolio
  - Documenting decisions and the reasons for them

Prudent Investor Rule

- Campbell – the prudent investor rule applied to a charitable remainder trust
  - In 1996, a 74-year-old woman established a CRT, naming a corporate fiduciary as trustee, funding the trust with stock of Exxon
  - The trust provided for a 10% unitrust interest, payable quarterly for the joint lives of husband and wife, and then to their children for life. The remainder was payable to five designated charities. The expected life of the trust was around 48-50 years, based on actuarial determinations. The initial asset allocation was 60-70% equities.
  - The settlor's income needs increased for family and health reasons and requested larger distributions from the trust. The trustee then shifted to a "growth" strategy, with a target allocation of 90% to equities. In 2000-01 the actual allocation to equities exceeded 98%. The settlor, apparently unfamiliar with investment strategy, was unaware of the additional portfolio risk.
  - The trustee communicated its acceptance of the change to a growth strategy in a letter to the settlor which made reference to the long-term time horizon for the trust.
  - The trust value declined from $943,000 in 1999 to $356,000 at the end of 2002. The allocation shifted to a "growth and income" goal, reducing equity allocation to about 60%, in 2002.
  - The Delaware Chancery court noted that the terms of the trust document must shape the trustee's responsibilities under the prudent investor standard
    - Long life of the trust in this scenario made a heavy allocation to equities necessary to serve the remainder interest (and even then the chances of leaving a remainder were slight)
    - The court declined to define "diversification" in terms of asset class instead of the individual securities held within the class
    - The trustee did not simply accede to the income beneficiary's wish for a higher payout in increasing the equity allocation, but the decision was reviewed by a trust officer, an investment officer, and a trust committee

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Diversification May Smooth the Ride

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Average
Commod 25.9%	EM-Mkt Stocks 56.3%	REIT's 38.0%	EM-Mkt Stocks 34.5%	REIT's 42.4%	EM-Mkt Stocks 39.8%	Dev-Mkt Bonds 11.4%	EM-Mkt Stocks 79.0%	Small-Cap Stocks 26.9%	EM-Mkt Bonds 8.5%	REIT's 28.7%	Small-Cap Stocks 38.8%	REIT's 15.9%	EM-Mkt Stocks 11.9%
Dev-Mkt Bonds 22.1%	Small-Cap Stocks 47.3%	EM-Mkt Stocks 26.0%	Commod 21.4%	EM-Mkt Stocks 32.6%	Commod 16.2%	Inv-Grade Bonds 5.2%	High-Yield Bonds 58.2%	Mid-Cap Stocks 25.5%	Inv-Grade Bonds 7.8%	EM-Mkt Stocks 18.6%	Mid-Cap Stocks 34.8%	Large-Cap Stocks 13.7%	REIT's 11.0%
EM-Mkt Bonds 13.1%	REIT's 40.7%	Intl Stocks 20.7%	REIT's 15.4%	Intl Stocks 26.9%	Intl Stocks 11.6%	Treasury Bills 2.1%	Mid-Cap Stocks 40.5%	REIT's 20.4%	Dev-Mkt Bonds 5.9%	EM-Mkt Bonds 18.5%	Large-Cap Stocks 32.4%	Mid-Cap Stocks 13.2%	Mid-Cap Stocks 10.2%
Inv-Grade Bonds 10.3%	Mid-Cap Stocks 40.1%	Mid-Cap Stocks 20.2%	Intl Stocks 14.0%	Small-Cap Stocks 18.4%	Dev-Mkt Bonds 11.3%	CPI 0.1%	REIT's 38.3%	EM-Mkt Stocks 19.2%	High-Yield Bonds 5.0%	Intl Stocks 17.9%	Intl Stocks 23.3%	60%, 40% Portfolio 10.6%	EM-Mkt Bonds 9.7%
REIT's 2.8%	Intl Stocks 39.2%	Small-Cap Stocks 18.3%	Mid-Cap Stocks 12.7%	Large-Cap Stocks 15.8%	Hedge Funds 10.0%	EM-Mkt Bonds -10.9%	Intl Stocks 32.5%	Commod 16.8%	60%, 40% Portfolio 5.0%	Mid-Cap Stocks 17.3%	60%, 40% Portfolio 17.7%	Inv-Grade Bonds 6.0%	High-Yield Bonds 8.8%
CPI 2.4%	High-Yield Bonds 29.0%	Bal Portf 4A Group 13.9%	EM-Mkt Bonds 10.7%	Mid-Cap Stocks 15.3%	Bal Portf 4A Group 8.3%	Hedge Funds -19.0%	EM-Mkt Bonds 28.2%	High-Yield Bonds 15.1%	CPI 3.0%	Small-Cap Stocks 16.3%	Bal Portf 4A Group 9.9%	EM-Mkt Bonds 5.5%	Small-Cap Stocks 8.6%
Treasury Bills 1.8%	Large-Cap Stocks 28.7%	Dev-Mkt Bonds 12.0%	Hedge Funds 9.3%	Bal Portf 4A Group 15.2%	Inv-Grade Bonds 7.0%	60%, 40% Portfolio -21.6%	Small-Cap Stocks 27.2%	Large-Cap Stocks 15.1%	Large-Cap Stocks 2.1%	Large-Cap Stocks 16.0%	Hedge Funds 9.3%	Small-Cap Stocks 4.9%	Bal Portf 4A Group 7.8%
High-Yield Bonds -1.4%	Bal Portf 4A Group 26.0%	EM-Mkt Bonds 11.7%	Bal Portf 4A Group 8.8%	Hedge Funds 12.9%	EM-Mkt Bonds 6.3%	Bal Portf 4A Group -25.2%	Bal Portf 4A Group 27.1%	Bal Portf 4A Group 13.7%	Treasury Bills 0.1%	High-Yield Bonds 15.8%	High-Yield Bonds 7.4%	Bal Portf 4A Group 4.9%	Large-Cap Stocks 6.7%
Hedge Funds -1.4%	EM-Mkt Bonds 25.7%	High-Yield Bonds 11.1%	Large-Cap Stocks 4.9%	High-Yield Bonds 11.8%	60%, 40% Portfolio 6.2%	High-Yield Bonds -26.2%	Large-Cap Stocks 26.5%	60%, 40% Portfolio 12.2%	Bal Portf 4A Group -0.7%	Bal Portf 4A Group 12.3%	REIT's 4.4%	Hedge Funds 3.6%	Intl Stocks 6.6%
Bal Portf 4A Group -1.8%	Commod 23.9%	Large-Cap Stocks 10.9%	Small-Cap Stocks 4.6%	60%, 40% Portfolio 11.1%	Mid-Cap Stocks 5.6%	Small-Cap Stocks -33.8%	Hedge Funds 20.0%	EM-Mkt Bonds 12.0%	Mid-Cap Stocks -1.5%	60%, 40% Portfolio 11.4%	CPI 1.6%	High-Yield Bonds 2.5%	60%, 40% Portfolio 6.5%
EM-Mkt Stocks -6.0%	Hedge Funds 19.6%	Commod 9.1%	60%, 40% Portfolio 3.9%	EM-Mkt Bonds 9.9%	Large-Cap Stocks 5.5%	Commod -35.6%	Commod 18.9%	Hedge Funds 10.2%	Small-Cap Stocks -4.2%	Hedge Funds 6.4%	Treasury Bills 0.0%	CPI 1.6%	Dev-Mkt Bonds 6.0%
60%, 40% Portfolio -9.5%	60%, 40% Portfolio 18.6%	Hedge Funds 9.0%	CPI 3.4%	Dev-Mkt Bonds 6.8%	Treasury Bills 4.9%	Large-Cap Stocks -37.0%	60%, 40% Portfolio 18.5%	Intl Stocks 8.2%	Hedge Funds -5.2%	Inv-Grade Bonds 4.2%	Inv-Grade Bonds -2.0%	Treasury Bills 0.0%	Hedge Funds 6.0%
Intl Stocks -15.7%	Dev-Mkt Bonds 18.6%	60%, 40% Portfolio 8.4%	Treasury Bills 2.9%	Treasury Bills 4.7%	CPI 4.1%	Mid-Cap Stocks -41.5%	Inv-Grade Bonds 5.9%	Dev-Mkt Bonds 6.8%	REIT's -5.8%	CPI 1.7%	EM-Mkt Stocks -2.3%	EM-Mkt Stocks -1.8%	Inv-Grade Bonds 5.0%
Mid-Cap Stocks -16.2%	Inv-Grade Bonds 4.1%	Inv-Grade Bonds 4.3%	High-Yield Bonds 2.7%	Inv-Grade Bonds 4.3%	High-Yield Bonds 1.9%	Intl Stocks -43.1%	Dev-Mkt Bonds 3.9%	Inv-Grade Bonds 6.5%	Intl Stocks -11.7%	Dev-Mkt Bonds 0.8%	Dev-Mkt Bonds -5.1%	Dev-Mkt Bonds -2.5%	Commod 2.7%
Small-Cap Stocks -20.5%	CPI 1.9%	CPI 3.3%	Inv-Grade Bonds 2.4%	CPI 2.5%	Small-Cap Stocks -1.6%	REIT's -47.7%	CPI 2.7%	CPI 1.5%	Commod -13.3%	Treasury Bills 0.1%	EM-Mkt Bonds -6.6%	Intl Stocks -4.5%	CPI 2.3%
Large-Cap Stocks -22.1%	Treasury Bills 1.1%	Treasury Bills 1.1%	Dev-Mkt Bonds -9.2%	Commod 2.1%	REIT's -7.0%	EM-Mkt Stocks -53.2%	Treasury Bills 0.2%	Treasury Bills 0.1%	EM-Mkt Stocks -18.2%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Treasury Bills 1.5%

Source: WMG Research; Morningstar EnCorr, as of 12/31/14. Information is for illustrative purposes only and does not represent the performance of any investment product. Past performance is no guarantee of future results. Please see Disclosures on slides 9-12 for Index definitions and definition of the Balanced Portfolio 4 Asset Group, and slide 8 for Asset Class Risks. An Index is unmanaged and not available for direct investment.

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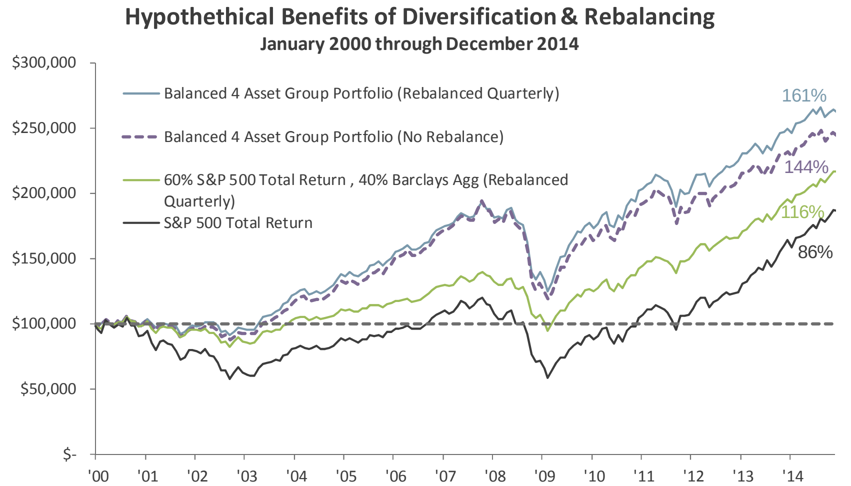
Asset Performance



Source: WMG Research; Morningstar, as of 12/31/2014. Balanced 4 Asset Group Portfolio is defined on slide 29. Balanced 4 Asset Group Portfolio performance is calculated using the representative asset class indices which are defined in the disclosure pages Past performance is no guarantee of future results. An Index is unmanaged and not available for direct investment.

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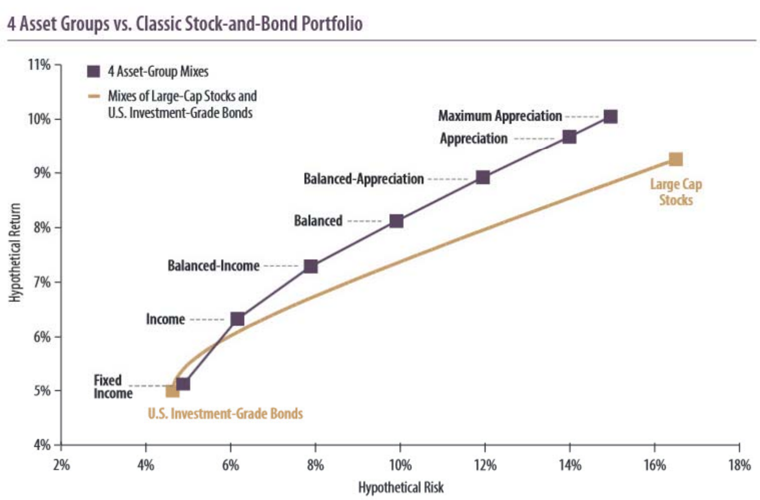

Source: Wells Fargo Wealth Management, June 2014

Why You Own Assets

Catastrophe
- Cash
- Short-Term Bonds
- Commodities
- Hedge Funds
- Managed Futures

Income
- Int-Term Bonds
- High-Yield Bonds
- Int'l Bonds (DM/EM)
- Large/Mid Cap Equity
- Int'l Equity (DM)
- Real Estate/REITs

Volatility
- Short/Int-Term Bonds
- Int'l Bonds (DM)
- Hedge Funds
- Managed Futures

Liquidity
- Cash
- Int-Term Bonds
- Int'l Bonds (DM)
- Large Cap Equity
- Int'l Equity (DM)

Inflation
- Short/Int-Term Bonds
- Int'l Bonds (DM)
- Domestic Equity
- Int'l Equity (DM/EM)
- REITs
- Commodities

Growth
- High-Yield Bonds
- EM Debt
- Domestic Equity
- Int'l Equity (DM/EM)
- Real Estate/REITs
- Private Equity

Some alternative investments and complementary strategies may be available to pre-qualified investors only.

UBTI and Alternative Assets

UBTI and Debt-Financed Income

- IRC § 664(a)(2)
  - Any UBTI realized by a charitable remainder trust is subject to a tax equal to the amount of the UBTI
  - Remainder of the CRT's income is unaffected, compared to the pre-2006 rule which disqualified the entire CRT in any year in which it realized UBTI (Newhall Trust)
    - State tax treatment
      - Until 2014, California did not follow the federal rule.
        - Starting on January 1, 2014, § 17755 applies normal UBTI rules to debt-financed income of a CRT
        - While not disqualifying the CRT, the change means that a CRT will pay total tax of more than 100% of any UBTI (the 100% federal excise tax plus the UBTI tax in California) UBTI
  - Although UBTI includes income from the conduct of a trade or business unrelated to a charitable function, for the most part a CRT or CLT runs into the issue mainly in connection with "debt-financed income"
  - "Debt-financed property" defined as property held to produce income and for which there is "acquisition indebtedness", in turn defined as the unpaid amount of debt
    - Incurred to purchase or improve the property;
    - Debt incurred prior to purchase or improvement if it would not have been incurred "but for" the acquisition or improvement of the property;
    - Debt incurred after the purchase or improvement of property if the debt would not have been incurred but for the purchase, and the debt was "reasonably foreseeable" at the time of purchase
  - UBTI earned through partnerships is taxable to the organization under § 512(c)
  - Income from controlled foreign corporations ("CFCs") under subpart F generally treated as dividend (nontaxable) income rather than UBTI (but note exception for CFCs engaged in insurance businesses – IRC § 512(b)(17))

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UBTI and Debt-Financed Income

- What is and is not acquisition indebtedness – the crucial distinction between implied leverage and actual borrowing
  - Buying securities on margin
    - Bartels cases – 501(c)(3) trust purchased securities on margin, generating income and gain. Despite strenuous arguments from the taxpayer, the Second Circuit (in 2000) and the Federal Circuit (in 2010) ruled that the resulting income and gains constituted debt-financed income
    - Similar results: Elliot Knitwear v. Comm'r, 614 F.2d 347 (3d Cir. 1980) (retirement plan purchased securities on margin)
  - Explicit borrowing to acquire new assets
    - Kern County Elec. Pension Fund v. Comm'r, 96 T.C. 845 (1991)(retirement fund borrowed from a bank, securing the debt with previously held CDs, and purchased new CDs with a higher yield; despite arguing that the transaction was tantamount simply to entering into a new CD with higher yield, the form of the transaction held)
      - Income from "securities loan" is not UBTI, but the transaction in Kern County was not a lending of securities for a fee, it was a loan secured by investment assets)
    - Borrowing against an insurance policy to acquire income-producing assets generates UBTI – PLR 8745013 (August 7, 1987)
    - Repo transactions treated as loans and generate interest income – Rev. Rul. 77-59, 1977-1 C.B. 196 (REIT entering into repo agreements generated qualifying interest income); Rev. Rul. 74-27, 1974-1 C.B. 24 (bank repo agreement involving specified securities was a lending transaction, not a purchase of the underlying securities)

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UBTI and Debt-Financed Income

- Transactions involving implied leverage not producing UBTI
  - Income and gains from "notional principal contracts" is excluded from UBTI – Treas. Reg. § 1.512(b)-1(a)(1)
    - NPC defined as a "financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount…."
    - Interest rate swaps
    - Equity swaps
    - Equity index swaps
    - "Similar agreements" (Treas. Reg. § 1.446-3(c)(1)(i))
  - Terminating payments – under § 512(b)(5), all gains and losses relating to investment activities from the lapse or termination of an option to buy or sell securities is not UBTI
  - Short sales of stock do not generate UBTI (Revenue Ruling 95-8, 1995-1 C.B. 107)
    - The obligation to deliver shares to close the short position is not "indebtedness" for purposes of § 514
    - Payments with respect to securities loans not taxable as UBTI – IRC § 512(b)(1)
  - Commodity futures – PLR 8104098 found commodity futures trading not to produce UBTI, even though to effect the trade an organization must open a margin account. The IRS concluded that a deposit in a margin account is to ensure performance, not to borrow funds to acquire investment assets
  - Equity derivatives and arbitrage transactions, including stock index futures and underlying equities (G.C.M. 39615, March 23, 1987)

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UBTI and Alternative Assets

- Many "alternative" asset classes, including hedge funds, use explicit leverage in their investing activities
- Certain REIT investments
  - Dividends from REITs generally do not generate UBTI (Rev. Rul. 66-106, 1966-1 C.B. 151)
  - REMIC residual interests – Rev. Rul. 2006-58, 2006-2 C.B. 876 (excess inclusion income from a residual interest in a REMIC held through a partnership is not UBTI to a CRT investor in the partnership)
  - Rev. Rul. 2006-58 preceded the change in law regarding the treatment of UBTI in CRTs; effect on REMIC investments?
- Real estate
  - Real estate investors typically, although not always, use a substantial amount of leverage in their operations
- Private equity
  - Routinely use leverage to make investments, although for buy-out funds the leverage may exist at the level of the target company
  - Funds may nevertheless borrow at the fund level, secured by capital call obligations, to make equity investments

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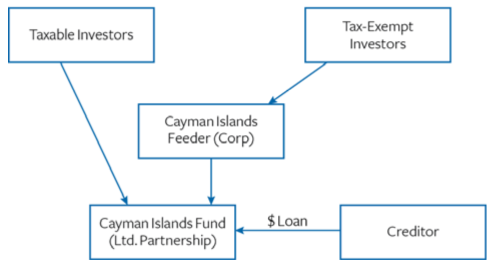
Dealing with UBTI

- The foreign "blocker" structure



- PLR 201043041 (October 29, 2010)
  - CRT created a wholly owned foreign subsidiary, a CFC
  - The CFC proposed invest in hedge funds which would use debt financing in their investment activities; apparently the CFC might also use debt financing in making investments
  - On the representation that the CFC would not engage in insurance activities, the Service ruled that neither subpart F income nor actual dividends from the CFC would constitute UBTI
  - Self-dealing issue: The CRT sought and received a ruling that funding and operating the CFC was not self-dealing; the CFC was not a disqualified person with respect to the CRT.
  - Other rulings come to similar conclusions (e.g., PLR 200251016 (December 20, 2002); PLR 200315028 (April 11, 2003))

Other Issues

PFIC Problem

- What if the foreign blocker entity does not qualify as a CFC?
  - Many investment funds establish blocker structures for a number of tax-exempt and foreign investors, preventing the entity from qualifying as a CFC
  - Such foreign blockers would typically fall within the definition of a "passive foreign investment company", or "PFIC"
    - IRC § 1297(a) defines a PFIC as a foreign corporation if
      - 75% of its gross income is "passive income", or
      - The average percentage of its assets produce, or are held for the production of, passive income
      - "Passive income" definition references the definition of foreign personal holding company income in §954(c)
        - dividends, interest, royalties, rents, and capital gains from the sale of property which produces passive income
- Application to CRTs (more specifically, income beneficiaries)
  - An "organization" exempt from tax under Chapter 1 of the Code isn't subject to the PFIC anti-deferral rules unless it receives a dividend which would be taxable under subpart F – Treas. Reg. §1.1291-1(e)
    - CRTs are exempt under §664, not §501(a), but if a CRT is an "organization" it would fall within that exception
    - Arguably a CRT is not an "organization", although the definition of that term is unclear
  - In any case, the income beneficiaries may be considered indirect owners of the PFIC by virtue of their interests in the CRT
  - If the CRT rules apply, investors cannot count on being able to address the situation by making a QEF election

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PFIC Problem – What to Do?

- Possible approaches
  - CFC approach, à la PLR 201051016
    - But cumbersome, especially for smaller CRTs
  - Where possible, the university endowment approach
    - E.g., PLR 201408032 (February 21, 2014): University acted as trustee of CRTs and was their remainder beneficiary. The university entered into a contractual arrangement in which it issued to the CRTs a contract right reflecting a proportionate interest in the value of the university's endowment. The cumulative value of the shares was to reflect the dollar value of their proportionate share of the endowment fund, and entitled the CRT to periodic distributions. The contract right conveyed no actual ownership interest in the endowment fund. The CRTs had no power to control, supervise, or review the university's investment decisions, and had no right to opt out of specific investments. The contract specified that the university was not a partner or agent of the trusts, and the CRTs had no liability for actions taken by the university. The Service ruled that the CRTs would not have UBTI from the arrangement, either from ongoing payments or upon redemption of shares.
      - Collateral issues: Payouts from the university to the CRT characterized as ordinary income, so the ongoing income tax treatment from the contractual arrangement is probably less tax-efficient than owning investment assets directly
        - Shares in the endowment treated as capital assets, so that gain or loss from a redemption of the contract right is characterized as capital gain or loss under §1234A of the Code: PLR 200735019 (June 1, 2007)

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PFIC Problem – What to Do?

- Possible approaches
  - Retail availability of comparable products
    - The UBTI problem arises where the investment occurs via an entity taxable as a partnership
    - A number of alternative strategies are now available in RIC form or other entities not taxable as partnerships
      - Some MLP funds, for example, have elected to be treated as C corporations so as not to flow through income and losses to investors
      - Growing "retail" presence of hedge funds in mutual fund format

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Net Investment Income Tax – IRC § 1411

- Does it make sense to harvest capital losses in a CRT?
  - Traditionally the answer depended substantially on the initial funding of the trust
  - Contribution of highly appreciated asset generated a large pool of capital gain
  - Subsequent loss realizations were not likely to eliminate the entire pool of capital gain, or at least not for a long period
    - Aggressive loss realization in that case would not reduce the income tax liability of the income beneficiary
- The impact of section 1411
  - Final regulations under § 1411 group post-2012 net investment income in each of the categories established under § 664
    - Maintains the "worst first" approach by classifying the first dollars distributed to income beneficiaries as coming from NII, if any exists in that category
    - Under the regular method, NII is distributed first, followed by other (pre-2013) income in that category, followed by NII in the succeeding category
    - Substantial amounts of pre-2013 income can therefore defer receipt of NII
  - Regulations will also permit a "simplified" method, which tracks the method in proposed regulations
    - Net losses against net investment income
    - May produce better after=tax results in some cases

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Deemed Dispositions

- Appreciated position contributed to CRT
  - Trustee then enters into a prepaid forward contract
    - Under normal tax rules, a properly structured contract can result in the receipt of cash without an immediate gain recognition (Rev. Rul. 2001-7; but see Anschutz v. Comm'r and subsequent rulings)
    - If the CRT makes a distribution of the cash to the beneficiary, can the beneficiary claim return of capital treatment (and therefore no tax) prior to maturity of the contract?
  - Treas. Reg. § 1.643(a)-8
    - Such transactions result in a deemed sale by the trust
    - Result applies when the CRT distributes cash in excess of
      - (i) cash contributed to the CRT which qualified for a charitable deduction, plus
      - (ii) the basis of any contributed property
    - The CRT then adjusts the basis of the property contributed to prevent further recognition of gain upon an actual sale of the property
    - Includes a general anti-avoidance rule

Disclosures

Important risk disclosures:

All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security.

Asset class risks considerations:

Hedge Funds are not suitable for all investors. Any offer to purchase or sell a specific hedge fund will be made by the product's offering documents. Investors could lose all or a substantial amount of their investments in these products. Hedge funds are available to persons who are "accredited investors" or "qualified purchasers" within the meaning of U.S. securities law. Hedge funds are not required to provide investors with periodic pricing or valuation and are not subject to the same regulatory requirements as other investment products. Hedge funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences. An investment in a hedge fund involves the risks inherent in an investment in securities, as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-U.S. securities, "junk" bonds, and illiquid investments.

Commodities: Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies, which may expose investors to additional risks.

Equity investments: Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.

Fixed income: Investments in fixed-income securities are subject to interest rate and credit risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. Government bonds are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although government bonds are considered free from credit risk, they are subject to interest rate risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Foreign investments: Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Real estate: There are special risks associated with an investment in real estate, including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Small- and mid-cap companies: The prices of small- and mid-company stocks are generally more volatile than large-company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions

Disclosures (cont'd)

Asset Class performance returns are based on the performance of representative financial indices for the periods shown. Financial indices are for illustrative purposes only, do not represent actual account performance, are unmanaged and are not available for direct investment. Representative performance figures assume cash holdings and reinvestment of dividends and/or earnings, but do not reflect account-level trading costs or fees. Representative performance figures do not reflect actual trading or material economic and market factors that would affect decision-making, as would be the case in managing actual client portfolios. Performance results in actual portfolios will be reduced by fees, actual trading costs and other expenses. Indexes represent securities widely held by investors. You cannot invest in an index.

Allocations and important definitions

Balanced Portfolio Four Asset (4A) Group = 3% Barclays US Treasury Bill 1-3 Months, 19% Barclays US Aggregate Bond Index, 5% Barclays US Corporate High Yield Index, 5% JPM GBI Global Ex-US TR USD Index, 4% JPM EMBI Global TR USD Index, 16% S&P 500 Index, 7.6% Russell Mid Cap TR USD Index, 3.8% Russell 2000 TR USD Index, 9% MSCI EAFE GR USD Index, 6.6% MSCI EM USD Index, 7% FTSE EPRA/NAREIT Developed TR USD Index, 4% Bloomberg Commodity TR USD Index, 2% HFRI Relative Value Arbitrage Index, 2% HFRI Macro Index, 3% HFRI Event Driven Index, 3% HFRI Equity Hedge Index.

Index definitions for slide 2

Treasury Bills: Barclays US Treasury Bill 1-3 Months Index
Commodities: Bloomberg Commodity TR USD Index
International Stocks: MSCI EAFE GR USD Index
Emerging Market Stocks: MSCI EM USD Index
Investment Grade Bonds: Barclays US Aggregate Bond Index
Hedge Funds: HFRI Fund Weighted Composite Index
REIT Equity: FTSE EPRA/NAREIT Developed TR USD Index
High-Yield Bonds: Barclays US Corporate High Yield Index
Developed-Market Bonds: JPM GBI Global Ex-US TR USD Index
Emerging Market Bonds: JPM EMBI Global TR USD Index and BofA Merrill Lynch Global High Yield & Emerging Markets Index
Large-Cap Equity: S&P 500 Index
Mid-Cap Equity: Russell Mid-Cap Index
Small-Cap Equity: Russell 2000 Index
CPI: U.S. Inflation rate
60% 40% Portfolio: is composed of 60% S&P 500 Index and 40% Barclays US Aggregate Bond Index.

Note: The historical returns are rebalanced monthly to target allocations at the beginning of each period. Representative performance figures do not reflect actual trading or material economic and market factors that would affect decision-making. Performance results in actual portfolios will be reduced by fees, actual trading costs, and other expenses. Returns assume reinvestment of dividends and other distributions.

Disclosures (cont'd)

An index is unmanaged and not available for direct investment.

Barclays U.S. Aggregate Bond Index is composed of the Barclays U.S. Government/Credit Index and the Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

Barclays Municipal Bond Index (from Lehman Brothers Municipal Bond Index) represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, and a remaining maturity of at least one year. The Index excludes taxable municipal bonds, bonds with floating rates, derivatives, and certificates of participation. The Barclays 10-Year Municipal Index is the 10 Year (8-12) component of the Municipal Bond Index.

Barclays U.S. Corporate High-Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

Barclays U.S. Treasury Bills (1-3M) Index is representative of money markets.

Bloomberg Commodity Index is a broadly diversified index of commodity futures on 20 physical commodities, subdivided into energy, U.S. agriculture, livestock, precious metals, and industrial metals sectors. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

BofA Merrill Lynch Global High Yield & Emerging Markets Index tracks the performance of the below investment grade global debt markets denominated in the major developed market currencies.

Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

HFRI Index is a fund-weighted (equal-weighted) index designed to measure the total returns (net of fees) of the approximately 2,000 hedge funds that comprise the Index. Constituent funds must have either $50 million under management or a track record of greater than 12 months. Sub-strategies include: HFRI Event-Driven, Distressed/Restructuring Index, and HFRI Event-Driven (Total) Index.

HFRI Indices currently consist of eight single strategy indices, an asset-weighted Global Hedge Fund Index, and HFRI Equal Weighted Strategies Index, each calculated pursuant to an index methodology. Most HFRI Indices are priced daily. All HFRI Indices are rebalanced quarterly.

HFRI Relative Value Index maintains positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types.

HFRI Equity Hedge Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Macro Index is composed of a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods. Although some strategies employ RV techniques, macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than realization of a valuation discrepancy between securities.

HFRI Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is composed of eight strategies: convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.

Disclosures (cont'd)

HFRI Event Driven Index maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance, or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Event driven exposure includes a combination of sensitivities to equity markets, credit markets, and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative) with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

NOTE: While the HFRI Indices are frequently used, they have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

JP Morgan Global Ex United States Index (JPM GBI Global Ex-US) is a total return, market capitalization weighted index, rebalanced monthly, consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.

JPM EMBI Global Index is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed-market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

MSCI All Country World ex U.S. Index (MSCI AC World Ex U.S.) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the U.S. The index consists of 45 country indices comprising 22 developed and 23 emerging market country indices. The developed market country indices included are: Australia,

Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI EAFE Index (Europe, Australasia, Far East) Index (MSCI EAFE NR) is a free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The index consists of the following 21 developed-market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI Emerging Markets Index (MSCI EM NR) is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. The index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The MSCI Frontier Markets Index consists of 22 countries tracking the performance of a range of equity markets that have become accessible to global investors.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Disclosures (cont'd)

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value.

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*Notes on Index Returns: Index Returns reflect previous business day's closing value with the exception of Hedge Fund Index returns which have a one day lag. Three-year returns are annualized.

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