

CHAPTER 7



CHARITABLE GIVING

Contributions to charitable organizations, such as churches, educational institutions, and community foundations, are often an important part of personal, financial and estate planning. Charitable gifts can be as simple as contributions to the charity or charities of your choosing. These are often referred to as “current” or “present” gifts. “Deferred” gifts, on the other hand, involve the contribution of an asset to a charity but the donor (or another person) retains the right to receive some benefit from the asset for a period of time.

The primary objective of most charitable gifts is to benefit the donor’s favored charities. Certain income, estate, and gift tax advantages can also be achieved through proper planning. The choice of assets to be contributed to the charitable organization, and the manner and timing of the contribution, will affect the tax consequences.

Charitable gifts may be made during the donor’s lifetime, at the time of death, or in combination. As with lifetime gifts, charitable gifts at death may be either outright for the immediate use of the charitable organization or deferred for use at a later date.

Donors who desire to achieve tax advantages from their charitable giving should ask three questions. First, what organizations should be the recipients of my charitable gifting? Second, what assets may I give to these organizations? Third, what are the tax benefits of the gift?

Qualified charitable organizations

Individuals may make tax-advantaged gifts to certain, but not all, charitable organizations. These organizations encompass a broad spectrum of entities, including public charities, educational institutions, hospitals, and religious organizations. In addition, deductible contributions may be made to other non-profit organizations, such as community foundations and private foundations. Gifts to governmental bodies also qualify for the charitable deduction.

However, not all nonprofit organizations qualify as a deduction for the donor. For example, donations to lobbying groups, political parties and candidates, and most gifts to service and fraternal organizations (such as a Rotary or Elks Club) do not qualify for a deduction. If you have any question as to whether your donation qualifies for a deduction, contact your tax professional. You may also

contact the IRS for its Publication 78 which is a cumulative list of qualified charitable organizations. It may be found at a local library or at www.irs.gov.

Assets that may be donated

Virtually any asset owned by the donor may be donated to a charitable organization. Intangible assets such as cash, stock, bonds and life insurance policies are frequently contributed to charities. Likewise, tangible assets such as real estate, artwork, and other collectibles may also be the subject of a charitable gift.

Intangible assets are generally preferred for donation to charity because such assets are relatively easy to transfer and can be put to immediate use for charitable purposes. The value of such assets may be determined from stock market quotations, insurance company records, or other published sources. Tangible assets, though also frequently donated, may be more difficult to value and transfer. For particularly large gifts for which the value cannot be easily determined (such as real estate), additional documentation (such as an appraisal) will be necessary in order to substantiate the value of the gift and the tax deduction available to the donor.

Income tax charitable deduction

The income tax deduction that is available for gifts to a charity depends on the type of asset donated, the organization to which it is given, and the donor's income in the year of the contribution. These rules are complicated but some general guidelines follow.

The starting point is to determine the donor's contribution base, which is the donor's adjusted gross income with certain adjustments. The maximum amount that a donor may deduct for income tax purposes as a charitable deduction in any year is 50% of his or her contribution base. However, this amount may be further limited as described below. If the value of the donor's charitable contributions exceeds the maximum amount he or she can deduct for the year, excess contributions may be carried forward for up to five subsequent tax years.

Donations of cash and most income-producing assets may be deducted up to 50% of the donor's contribution base. However, donations of appreciated property such as stock or real estate, may only be deducted up to 30% of the donor's contribution base. Thus, the type of asset contributed to the charity may affect the amount of the deduction that can be taken in any year. A donor may make contributions of both 50% property and 30% property in the same year.

The percentage limitations described above may be further limited based on the type of organization receiving the donation. Gifts to public charities, including community foundations, qualify for the 50% limit (unless the gift is of 30% property). These organizations are of the kind that qualify under

Section 501(c)(3) of the Internal Revenue Code, and thus are often referred to as “501(c)(3) organizations.”

Other organizations such as veterans groups, fraternal orders and cemetery societies, known as semi-public charities, do not receive the same treatment. Contributions to these organizations may only be deducted in an amount of up to thirty percent (30%) of the donor’s contribution base.

Finally, contributions to private foundations (often referred to as “family foundations”) are further limited to twenty percent (20%) of the donor’s contribution base. In addition, the charitable contribution of certain assets contributed to a private foundation may be limited to the donor’s tax basis (usually its acquisition cost), rather than its fair market value at the time of the contribution.

Estate taxes and the estate tax charitable deduction

The Internal Revenue Code imposes a tax on the assets of a decedent owned at the time of death. The estate tax may also apply to assets not owned by the decedent but over which he or she had some form of legal control at death. Many states have estate tax as well.

Gifts to charity made at death qualify for the estate tax charitable deduction. Like the income tax charitable deduction, the value of assets transferred to a charitable organization will reduce the value of assets subject to taxation. The types of organizations that qualify for the estate tax charitable deduction are substantially the same as those that qualify for the income tax charitable deduction.

However, unlike the income tax charitable deduction, the estate tax deduction allows the decedent’s estate to reduce the assets subject to estate tax on a dollar-for-dollar basis, without limitation. Thus, transfers to charity as part of your estate plan can completely eliminate the estate tax that would otherwise be payable.

Gift taxes and the gift tax charitable deduction

The Internal Revenue Code taxes transfers during lifetime in much the same manner as transfers at death. As with the estate tax, the donor can offset any gift tax by applying his or her gift tax applicable credit amount (currently \$1 million) to the transfer.

Consistent with the estate tax rules, a donor will be able to take a charitable deduction for any gift transfer to qualified charities, which essentially makes the gift to the charity tax free. However, depending on the amount and type of transfer, a Gift Tax Return (IRS Form 709) may be required. In addition, certain split-interest transfers, such as to a charitable remainder trust or a charitable lead trust, will result in a gift tax where someone other than the donor and the charity receive some benefit from the trust.

Deferred charitable gifts

Many people desire to make significant contributions to favored charities but wish to retain the right to use or receive income from the donated property. This may be accomplished through a variety of structures. For example, a person may give their home or farm to a charity but retain the right to reside in the residence or continue to use the farm for his or her lifetime (referred to as a “life estate”). Assets may also be contributed to a charitable trust (known as a “charitable remainder trust”) allowing the donor to retain a stream of income from the trust for a term of years or life. With these strategies, a current income tax charitable deduction is allowed for such gifts, and the assets will not be included in the donor’s estate for purposes of calculating the estate tax due on a donor’s death.

CHARITABLE REMAINDER TRUST

A charitable remainder trust (CRT) is a form of deferred giving strategy that allows the donor to make a charitable contribution but retain the right to use the donated property (within certain limitations) for a term of years or for life. The CRT is divided between an income interest, usually for the benefit of the donor, and the remainder interest for the benefit of one or more charitable organizations. A CRT is often referred to as a “split-interest trust” for this reason.

A CRT may be in one of two forms: a charitable remainder unitrust (CRUT) or a charitable remainder annuity trust (CRAT). The choice of CRT to be used will depend on a variety of factors including the benefits to be received by the donor during the term of the CRT and the type of asset contributed to the CRT.

The CRT may be established to pay income to the donor for a term not to exceed 20 years or for the donor’s life (which may exceed 20 years). In addition, the CRT may be established to benefit successive lives (for example, for the lifetime of the donor and then for the lifetime of the donor’s spouse) or may benefit someone other than the donor altogether (although the income interest for someone other than the donor or his or her spouse will be subject to gift tax).

The income interest reserved by the donor is generally fixed under the terms of the CRT as a percentage of the trust assets. Once fixed, the percentage may not be changed. The minimum percentage payout is five percent of the value of the trust assets. The maximum payout is also fixed based on several factors including the age of the donor, term of the CRT, and prevailing interest rates.

The primary distinction between the CRAT and the CRUT is the determination of the income interest paid to the donor. If the donor selects a CRAT, the trust will pay a fixed annuity to the donor, based on

the value of the assets contributed to the CRT at the time it is created. For example, if \$100,000 is contributed to a CRAT with a five percent income interest, the donor will receive an annual payout of \$5,000. This amount will not change regardless of any change in the value of the trust assets over time. This approach may be preferred when the donor wishes to have an income stream that he or she can rely on for the trust term.

Alternatively, if the donor selects a CRUT, the income interest will be re-determined each year based on the value of the trust assets. If the CRUT increases in value, the income interest will also increase. In the above example, if the trust assets increased from \$100,000 in the first year to \$120,000 in the second year, the payout year would be \$6,000 (five percent of \$120,000). The CRAT, on the other hand, will continue to pay \$5,000 regardless of any change in value.

When the CRT income interest ends (either at the end of the set number of years or the death of the donor or other designated non-charitable beneficiary) the remaining assets pass to the designated charitable organization(s). Even though the CRT is an irrevocable trust, the donor may retain the right to change the charitable beneficiaries. The donor may also serve as his or her own trustee during the trust term (with certain limitations) or may select someone else to be the trustee.

One of the most significant benefits of the CRT is that the donor receives an immediate income tax charitable deduction even though the assets will not pass to the charity(ies) until some time in the future. This deduction is limited under the same rules set out in this chapter. In essence, the income tax charitable deduction is equal to the value of the assets contributed to the CRT, reduced by the value of the income interest retained by the donor. This value is determined under certain provisions of the Internal Revenue Code. The longer the payout to the donor or the higher the payout percentage, the smaller the charitable deduction.

Another important benefit of a CRT is that the sale of appreciated assets contributed to the trust or purchased by the trustee will not result in taxation of the capital gain. A CRT is a tax-exempt entity. For example, if the donor contributes a highly appreciated asset (such as stock or real estate) to the CRT, the asset may be sold and the donor will not have to pay the capital gains tax on the sale. As a result, the trustee may reinvest the full amount of the sale proceeds from the sale of the appreciated asset. This will likely increase the income interest compared with selling the same asset and reinvesting the sale proceeds after paying capital gains taxes.

The payout of the income interest is taxable income to the recipient (either as ordinary income or capital gain) unless the distribution is from the donor's basis in the property contributed to the CRT. Specific rules apply to the order of priority that apply to the tax characteristics of the payout.

If the CRT terminates at the donor's death, the assets are included in the donor's estate for purposes of determining the estate tax due. However, the donor's estate will receive a charitable deduction for the amount distributed to charity. Thus, the donor's estate tax liability is reduced. As indicated above, if the CRT is designed to benefit a person other than the donor or his or her spouse (either during the donor's lifetime or at death), the value of the income interest that benefits someone other than the donor or his/her spouse will be considered a taxable gift. In turn, the use of the donor's gift tax exclusion will affect the applicable credit amount available to the donor's estate to offset estate taxes.

CHARITABLE GIFT ANNUITY

Similar to a CRAT, a donor may establish a charitable gift annuity with a charitable organization that is authorized to issue annuities. The donor will receive a charitable deduction calculated in a manner similar to that of a charitable remainder trust. However, unlike the charitable remainder trust, the donor may not manage the assets contributed to the charity in the form of a charitable gift annuity. It is nonetheless a valuable alternative to the complexities associated with a CRT, especially for smaller deferred charitable gifts.

Many charitable organizations are qualified to issue charitable gift annuities. The amount of the annuity that is payable to the donor and the amount of the charitable deduction will depend on the donor's life expectancy and the prevailing interest rate environment. Gift annuities may also be established for more than one person; for example, for the lives of both the donor and his/her spouse. Annuity payments may begin immediately or be deferred to a later date. In most circumstances the interest rate offered by a charitable organization on a charitable gift annuity is established by the Committee of Gift Annuities.

The contribution of cash or assets to a charity in exchange for a gift annuity is a complicated transaction since it is composed of both a charitable gift as well as the purchase of an annuity. The gift annuity becomes a general obligation of the organization issuing it. Furthermore, the gift of appreciated assets in exchange for the gift annuity will result in recognition of capital gain by the donor. However, if certain requirements are met, the capital gain is reportable over the life of the annuity, and not all in the year the annuity was acquired. Thus, a portion of each annuity payment will be treated for income tax purposes as capital gain.

CHARITABLE LEAD TRUST

Another form of split-interest trust is a charitable lead trust (CLT). As with a CRT, a CLT may be either in the form of an annuity or unitrust. However, unlike a CRT, the CLT is not a tax-exempt entity and there is no minimum or maximum payout requirement.

A CLT is the reverse of a CRT. The income interest is paid to a charitable organization for a term of years and the remainder interest is paid to non-charitable beneficiaries (such as the donor's children). The value of the remainder interest payable to the non-charitable beneficiaries is a taxable gift of a future interest.

The determination of the charitable deduction will depend on the type of CLT selected by the donor. If the CLT is designed to be a grantor trust for income tax purposes, the donor receives an income tax charitable deduction for the present value of income interest payable to the charity over the term of the trust. This deduction may be used in the year in which the CLT is established and funded, and is subject to the five-year carry forward rules discussed above. However, as a grantor trust, the income of the CLT will be taxed to the donor as well. If, on the other hand, the CLT is designed to be a complex trust for income tax purposes, the income of the CLT will be taxed to the trust (not the donor) and the income tax payable can be offset by each year's distribution to the charity as a charitable contribution.

The primary advantage of the CLT is that the value of the transfer to the non-charitable beneficiary is reduced by the value of the income interest paid to the charitable organization during the trust's existence. A CLT is beneficial to donors who wish to make a commitment to a charitable organization for a period of years but have non-charitable beneficiaries (such as children) be the ultimate recipient of their estate. An added advantage of the CLT is that the appreciation of the assets in the CLT will pass to the non-charitable beneficiaries without additional gift or estate tax.

Community foundation

In general, a community foundation is a grant-making organization that receives donations from donors and makes distributions to charities on a periodic basis. A community foundation may hold and invest the contributions in either common or separate accounts, and may serve as the trustee of trusts (such as a charitable remainder trust) established by donors. Generally, though not exclusively, a community foundation makes grants to charities in the community in which the foundation is located.

One of the principal advantages of making contributions to a community foundation is that the donor receives the most favorable income tax deduction for his or her contribution since the community foundation is a 501(c)(3) organization. Contributions of cash or income-producing property are subject to the 50% limitation, and contributions of appreciated property are subject to the 30% limitation.

Another advantage of making contributions to a community foundation is that the donor or the donor's family may have a significant level of involvement in the process of selecting the charitable recipients of the distributions from the community foundation. For example, the donor may make recommendations each year regarding how the income from the donor's fund will be used in achieving the donor's charitable objectives in the community. However, the donor's input is in the form of advice only; the final decisions rest with the community foundation's board of directors.

Private foundations

Donors who wish to exercise substantial control over the use of the donor's charitable contributions will often select a private foundation for this reason. Unlike a community foundation, a private foundation is not publicly supported. Generally, a single donor (or a small number of individuals close to the donor) will be the sole source of support for the private foundation. Donors will often establish a private foundation in a year in which the donor wishes to pre-fund his or her charitable giving for several years in advance in order to achieve the most economic income tax result.

The primary advantage of the private foundation is that it will allow the donor almost complete control over the use of the donated funds. The process of selecting the charitable organization to which funds will be distributed from the private foundation is completely within the control of the board of directors of the foundation. The donor, his or her family members, friends and other advisors will often comprise the board of directors of the private foundation. For this reason private foundations are often used by parents to instill in their children the sense of charitable giving and commitment to the community.

However, this level of control and flexibility comes with a cost. Private foundations are subject to a myriad of rules regarding the operation of the foundation, including prohibitions against using the foundation to achieve non-charitable purposes (so called "self dealing"). Private foundations are also subject to certain taxes that do not apply to public charities. In addition, private foundations must file an application with the Internal Revenue Service in order to be approved as a tax-exempt organization. Furthermore, annual reports regarding the financial activities of the private foundation must be filed with the Internal Revenue Service and the state in which the corporation or trust was established.

Private foundations are also subject to special limitations with regard to the income tax deduction available to the donor. Cash and income producing assets are limited to 30% of the donor's contribution base and gifts of appreciated assets are further limited to 20% of the donor's contribution base. Certain contributions (such as stock in a closely held business) are subject to additional limitations.

Finally, if the donor is allowed to participate in the decisions of the board of directors regarding the recipients of the distributions from the foundation, the contributions to the private foundation may be includable in the donor's estate for estate tax purposes. The Internal Revenue Code provides that assets that are gifted but subject to the donor's control will be included in the donor's estate at death. Thus, certain additional steps must be taken to shield the donor's estate from this result if the purpose of the gift to the foundation is to achieve both income and estate tax savings.

Charitable gifts at death

Making charitable gifts at the time of death is a preferred approach for many individuals. During lifetime, the donor may have the full use and enjoyment of the property. At death, the donor's will or living trust must describe the terms of distribution to the charitable organization. For example, a donor's will may set out a specific amount or assets to be distributed to the charitable organization. Alternatively, the donor might state that a percentage of his or her estate will be set aside for charitable purposes. Donors should discuss these options with their advisors.

In addition, the split-interest trust options (charitable remainder trust or charitable lead trust) outlined above may be utilized at death, but with somewhat different tax consequences than as previously discussed. For example, a donor may include provisions in his or her will to establish a CLT at the time of his or her death. The CLT will benefit the designated charity for a term of years. At the end of the term, the CLT terminates in favor of the donor's children (or other non-charitable beneficiaries).



If the contribution meets certain qualifications, the donor's estate is entitled to a deduction for the full fair market value of the assets passing to the charitable organization and is not limited in the same way as the income tax charitable deduction. Thus, the estate tax can be substantially reduced or eliminated by making a contribution to a charitable organization.

Certain assets such as retirement plan benefits, individual retirement accounts, tax-deferred annuities, contracts for the sale of appreciated assets and deferred compensation agreements have income tax consequences that survive the decedent. These assets are known as "income in respect of a decedent" or "IRD."

The heirs of the decedent (or worse, the decedent's estate) must pay the income tax. Often the income tax consequences to the heirs of the decedent will be far greater than if the decedent had paid the tax during his or her lifetime. The income tax on such assets, when combined with the estate tax, can exceed eighty percent of the value of the asset.

One estate planning opportunity for donors with assets that constitute IRD is to designate such assets for charitable purposes. For example, the donor may name a charity as the beneficiary of his or her retirement plan, individual retirement account, or tax-deferred annuity. Since the charity is a tax-exempt organization, it will not have to pay the income tax that a non-charitable beneficiary (such as the donor's heirs) would have to pay.

Coordinating the estate plan to take into consideration assets that constitute IRD is highly complicated, particularly where the donor has both charitable and non-charitable beneficiaries. The donor should seek the advice of a qualified tax advisor before implementing an estate plan under such circumstances.

Conclusion

There are many strategies available to achieve your charitable giving objectives. The tax rules regarding charitable giving are complicated. However, with proper planning, you can promote the mission of your preferred charities and achieve tax benefits as well.