

# Tax-Effective Charitable Giving<sup>1</sup>

## *A Review of the Potential Tax Benefits From Charitable Gifts*

Charitable giving starts with a desire to help support a cause or further a charitable goal of importance to the donor. Through deductions from taxes, the federal and state governments support private philanthropy and offer to reduce the costs of your charitable gifts by reductions to your tax bill. In order to take advantage of those deductions, or at least to maximize the potential benefits, it is important to plan in advance the timing and form of your gifts.

Giving can be as simple as a direct and outright donation. Current, regular gift programs are common, whether the recipient is the donor's church, school, civic organization or public charity. However, sometimes we wish to make gifts which are not part of a regular program, whether because the size of the gift is large, the subject of the gift is property other than cash, or because we wish to make a commitment but defer some or all of the gift to a later date or until death.

This memorandum discusses some of the forms of charitable giving which can be tax effective. Since many of the techniques can be quite complex, donors should consult with the donee and with their tax advisors when implementing advanced techniques. In most cases, large or complex gifts should be planned in coordination with comprehensive personal estate planning. Some planned giving will involve direct transfers while some will involve trust arrangements.

### *Gifts Not Requiring Trust Arrangements*

#### *Outright Gifts to a Public Charity*

An outright gift of property to a public charity has many advantages. The donor generally gets an income tax deduction and the property is removed from his estate for estate tax purposes.. The charity gets the immediate use of the property. The donor can witness and enjoy the benefit to the charity derived from the gift. The donor may, but need not, place restrictions on the use of the property as agreed between the donor and the charity.

The income tax benefit from outright gifts depends in part on the nature of the property given. For example:

---

<sup>1</sup>

Money:	Deductible up to 50% of the donor's adjusted gross income. If the gift exceeds that limitation, the excess can be carried over and used in future years for up to five years.
Securities and Real Estate Held Long-term:	Deductible at full present fair market value. Any appreciation over basis escapes the capital gain tax. The deduction is limited to 30% of adjusted gross income.
Securities and Real Estate Held Short-term:	Deductible up to the cost basis or fair market value, whichever is lower. Deductible up to 50% of adjusted gross income with excess permitted a five year carry-over.
Ordinary Income Property	Certain types of what appear to be capital assets would generate ordinary income if sold by the donor. Examples are inventory, crops, and artwork created by the donor. These are deductible on the same basis as short-term securities and real estate.
Tangible Personal Property Held Long-term (works of art, antiques, books)	<i>Related Gifts:</i> Deductible to full present fair market value with no capital gains tax on appreciation if the property is related to the donee's exempt charitable function (for example, a work of art given to an art museum). Deductible up to 30% of adjusted gross income with five year carry over available.
Tangible Personal Property Held Short-term	Deductible up to the cost basis or fair market value, whichever is lower. Deductible up to 50% of adjusted gross income with excess permitted a five year carry-over.

For gifts of securities, real estate or tangible personal property held long term, the 30% of adjusted gross estate limitation can be raised to 50% provided that (i) the claimed value of all gifts of such property is reduced by 100% of all appreciation over basis and (ii) the claimed value of all gifts being carried over from prior years under the five year carryover rule are similarly reduced.

If the outright gift is to a private foundation rather than a public charity, the deduction for gifts of securities, real estate and tangible personal property held long-term is generally limited to the lower of cost basis or fair market value. There are exceptions to this rule. If the private foundation is a “pass-through” foundation, meaning that it distributes an amount equal to its contributions within 2 ½ months following the year of receipt, the value of the gift is determined in the same manner as though the gift had been made to a public charity.

A deduction is allowed for the full fair market value of stock if the stock is a security for which quotations are readily available on an established securities market. However, publically traded stock which is subject to restrictions on sale under SEC Rule 144 are deductible only at cost basis.

The ceiling for the income tax deduction for gifts to a private foundation are generally limited to 30% of adjusted gross income with the five year carry over for any excess available. The ceiling is limited to 20% of adjusted gross income for gifts of capital gain property. If the gifts are made to a pass through private foundation, the limitations are the same as if the gift had been made to a public charity.

A private foundation is an organization which exists for a public purpose but which is either controlled by a small group (frequently a family) or which obtains its support from a limited number of persons.

#### *Bargain Sales*

A bargain sale is a sale of property in which the amount of the sales proceeds is less than the property’s fair market value. When a bargain sale is made to a charitable organization, the excess of the fair market value of the property over the sales price becomes a charitable contribution to the charity.

The taxpayer reports both a sale and a charitable contribution. The income tax basis of the property must be allocated between the sale and gift elements on the basis of the relative values. For example, if the donor sold property worth \$100,000 having a \$50,000 basis to the charity for \$60,000, only 60% of the basis could be allocated to the sale element of the transaction. In this example, the donor has proceeds of \$60,000 reduced by an allocated basis of \$30,000 for a taxable gain of \$30,000. The donor also has a charitable contribution deduction of \$40,000.

#### *Remainder Interest in a Personal Residence or Farm*

A personal residence means any property used by the donor as a personal residence and need not be the principal residence. A vacation home, even a yacht with sleeping and cooking facilities, can qualify. The residence does not include household furnishings or other tangible personal property located in the residence. A farm is defined as any land and its improvements which is used

by the taxpayer for the production of crops, fruit or other agricultural products or for the sustenance of livestock.

The donor retains the use of the property either for life or for a predetermined term of years. The donor may retain the right to continue the use of the property during the joint lives of the donor and spouse. The amount of the income tax deduction is determined based on the value of the gift at the time it is made. To determine this, the fair market value of the property is reduced by a factor calculated to quantify the value of the continuing use by the donor.

For example, if donors age 65 and 60 gift property having a value of \$100,000 to a charity in April, 2001, retaining the right to continue to use the property until they both die, the value of the remainder interest is approximately \$26,418 which would be the amount of the charitable deduction.

#### *Undivided Interests*

The gift of an undivided interest in property is a gift of a fractional interest. The deduction is measured by the fair market value of the property times the fractional interest given to the charity.

For example, suppose the owner of an oil painting valued at \$100,000 gives the painting to an art museum with the reservation that the donor will have possession of the painting for six months of the year. The donor will receive a charitable contribution deduction of up to \$50,000.

#### *Conservation Easements*

An easement is the grant of the use of land to a charity for certain conservation purposes. It also might be a self-imposed restriction on the use of your land. For example, you might grant to the United States an easement prohibiting you from developing your land which is adjacent to a national park. The easement must be perpetual.

Conservation purposes include:

- public outdoor recreation;
- protection of wildlife habitat or ecosystems;
- preservation of open space for public benefit; and
- preservation of historically important land or historic structure

With certain restrictions, the grant of an easement may generate an income tax deduction. Under special rules, it may also generate an estate tax deduction. The amount of the deduction is generally the fair market value of the property before the easement minus the fair market value of the property after the easement.

### *Works of Art and Copyright*

A work of art and its copyright have generally been considered to be two interests in the same property. Generally, to obtain an income tax deduction the gift of the art must include the gift of the copyright if both are owned by the donor. However, if a donor owns only the copyright and not the art itself (or vice versa), the donor can contribute all that the donor owns and obtain an income tax deduction.

A work of art is not considered a “capital asset” in the hands of its creator or in the hands of a donee of the artist. Therefore, an artist who gives his or her work to charity will get an income tax deduction only to the extent of the artist’s basis (generally his cost of materials).

For estate tax purposes, the entire interest rule does not apply. The owner of a work of art and its copyright may contribute either and obtain an estate tax deduction for the fair market value of the contribution. Of course, the donee must be a qualified charitable organization and the donated art must be related to the charity’s exempt purpose to obtain a deduction equal to fair market value.

### *Charitable Gift Annuities*

The charitable gift annuity is one of the most common forms of gift which provide an income back to the donor. It is popular because of its simplicity. Often the individual who funds a private annuity can reduce his taxable estate, retain an income from the property, get a current income tax deduction, and achieve a charitable objective.

The annuity is a contract between the individual and the charity. The individual gives the charity a sum of money and the charity agrees to provide the individual with a periodic fixed payment. The periodic payment (usually quarterly) is based on the annuity percentage agreed to by the parties and the age of the annuitant (the donor).

The charity will generally offer an annuity rate which is suggested by the American Council on Gift Annuities, a volunteer organization that recommends the annuity rates. Although these rates are not binding on charitable organizations, most do follow them in order to prevent rate competition between charities.

The number of annuitants cannot exceed two. The income tax treatment of the annuity payments depends on the nature of the property given. For example, the donor’s basis is recovered equally over each annuity payment over the donor’s life expectancy. If there is an unrealized capital gain, the gain will also be partially recognized with each annuity payment over the course of the donor’s life expectancy. The return of basis is tax free. The higher the basis, the less of the annuity is taxable. Therefore, each annuity payment could consist of ordinary income, capital gain and tax free return of basis.

Annuity payments can be immediate or deferred. By deferring payments, both the annuity rate and the income tax deduction increase because the projected present value of the payments is less. For example, if a donor age 60 entered into a charitable gift annuity contract the annuity rate would be 6.7% and the percent deductible would be 26.5%. If the same donor deferred the beginning of the annuity payments until age 70, the annuity rate would be 12.4% and the percentage deductible would be 51%.

A charitable remainder trust should be considered rather than a charitable gift annuity if the donor wishes to have more than two annuitants, the donated property is hard to value, the gift is large in value or the donor wishes to retain the flexibility to change the charitable donees.

### *Gifts Requiring a Trust or Other Formal Structure*

#### *Charitable Remainder Trusts*

A charitable split-interest trust is one in which both a charity and at least one person have an interest. The two interests are divided into an income interest (a right to receive an income from the trust for a period of time) and a remainder interest (the right to receive what's left when the income interest terminates). Each of these two interests has a value. The sum of those values is the value of the property contributed to the trust. There are two types of split-interest trusts: one in which the person owns the income interest (the charitable remainder trust) and one in which the charity owns the income interest (the charitable lead trust).

With a charitable remainder trust, a donor transfers property to an irrevocable trust. He, or he and his spouse, retain the right to receive an annuity from the trust for life or for a term of years. At death, or when the term expires, the trust terminates and the charity receives everything left in the trust at that time. Until the trust terminates, the charity receives nothing from the trust.

The annuity can be expressed as either a fixed percentage or as a fixed dollar amount. If it is a fixed percentage, it is referred to as a unitrust. The percentage is applied to the fair market value of the property each year. Thus, if the property increases in value, the annuity payment will increase. The fixed dollar option, on the other hand, protects the donor against decreases in property value.

The donor can be the trustee and retain the right to manage the property. He can retain the right to name additional charities or delete charities from the list of those which are to receive the trust fund when the trust terminates. The trust is considered to be a charitable trust even though the donor retains the right to the annuity; therefore, any capital gains from sales of assets by the trust are not taxed. Finally, because the value of the remainder interest is irrevocably given to charity when the trust is created, the donor receives an income tax deduction in the year of the gift for the value of the charities remainder interest.

For example, assume a husband and wife aged 55 and 53 respectively give \$100,000 to a charitable remainder trust retaining the right to receive a 5% annuity (calculated as a unitrust) for the

remainder of their lives. If this gift were made in April, 2001, the value of the charity's remainder interest is \$23,377 and the couple would receive an income tax deduction in that amount. The amount of the income tax deduction is a function of several variables including the IRS discount interest rate for the month of the gift and the ages of the annuity recipients. For a second example, a single donor age 70 who contributes the same \$100,000 would receive an income tax deduction of \$54,673 .

The charitable remainder trust is often coupled with a concept called a "wealth replacement trust." Under this plan, the donor uses the cash saved with the income tax deduction to purchase life insurance on his life. This life insurance is owned by a separate irrevocable life insurance trust so that the proceeds of the life insurance will be income and estate tax free at the donor's death. Therefore, while the charitable remainder trust fund will pass to the charity, the insurance proceeds will be used to replace for the family the wealth passing to charity. This is said to be a "win-win" plan since both the charity and the family benefit.

### *Charitable Lead Trusts*

The charitable lead trust is the opposite of the charitable remainder trust. In the lead trust, the annuity is given to charity for a term of years. Since there is no income tax deduction for the donor from a lead trust, it is typically created and funded only at the donor's death. The lead trust is designed to create an estate tax deduction at the donor's death but with the property returning to the family after a term of years.

The annuity must be at least 5% but can be larger. The larger the annuity and the longer the term the greater the estate tax deduction enjoyed by the donor's estate. In fact, the estate tax deduction can be as high as 100%. For example, if a donor died in April, 2001, leaving \$100,000 in a charitable lead trust paying a 7% annual annuity to charity for 20 years, the estate tax deduction would be \$80,289. If the annuity were 8.72% for 20 years, the estate tax deduction would be 100%.

By delaying the family's right to receive the property for a term of years and giving a portion of the income to charity, the property eventually comes back to the family with a significant estate tax savings. If in our example the donor had been in a 55% federal estate tax bracket, his family would have received only \$45,000 without the charitable lead trust. If the trust can earn an income sufficient to pay the 8.72% annuity annually for 20 years, the family will receive the full \$100,000 plus income in excess of the annuity compounded over the term of the trust. Meanwhile, the family controls the investment of the trust fund and the selection of the charities which receive the annual annuity. This technique is particularly attractive in larger estates where the family can afford to do without the personal benefit of the trust fund for the term of years.

Obtaining an estate tax deduction for contributions to a charitable lead trust does not necessarily mean that the remainder interest may not be subject to a generation-skipping tax if the remainder passes to grandchildren or younger family members.

The charitable lead trust is generally used only in testamentary situations. Unlike the charitable remainder trust, no income tax deduction is generated by a lifetime gift unless the trust is structured so that the donor remains personally taxable on all of the income of the trust for the entire term of the trust. Since this is usually too high a price to pay, donor's typically fund a charitable lead trust as a part of their estate plan.

### *Private Foundations*

A private foundation is an organization which exists for a public purpose but which is controlled by a limited group of persons (usually a family) or has a limited group of contributors (also usually a family). A private foundation may be formed as either a charitable corporation or a trust. In either case, the foundation must qualify as a charitable organization under the Internal Revenue Code. All of its interests must be held for the benefit of one or more charitable, religious, educational or other organizations which are themselves listed as tax-exempt by the IRS. The trustees of the foundation trust (or directors if the foundation is formed as a corporation) are authorized to invest and distribute the funds to qualifying charitable recipients.

A foundation generally is treated as a "private foundation" which is a specifically defined type of charitable organization under the tax laws. It will be a private foundation because it will typically not have a sufficiently broad source of support to qualify as a public charity. When classified as a private foundation, it must distribute at least 5% of its net investment assets each year, pay a 2% excise tax on net investment income, not make investments which would jeopardize its charitable purpose, not engage in self-dealing with principal donors or others who are disqualified, not make taxable expenditures (including certain contributions to individuals) and may not hold more than 20% of the stock of a closely-held business enterprise. Failure to comply with these rules will result in substantial excise taxes and could result in the loss of its qualified status as a tax-exempt foundation. In addition, a private foundation may not engage in lobbying and must file annual tax returns.

In spite of these onerous requirements, many families choose to establish and contribute to their family foundations during their lifetimes and may make substantial gifts at death. One reason for the popularity of family foundations is the ability of the family to control the disposition of the dollars set aside in the foundation for charitable purposes. Many people believe that their children and heirs should be taught the principles of philanthropy and be expected to give back to society some of the wealth which the family has been able to accumulate. Family members may not only serve as trustees or directors (with the ability to manage the foundations assets and to choose the charitable beneficiaries annually) but may also, with some limitations, receive a salary for serving. Family foundations may be designed to exist perpetually, creating a memorial to the family and a vehicle for charitable giving which can serve the family for many generations.

A family foundation may be used in connection with a charitable split-interest trust. If so, the charitable distributions, whether the lead income interest or the remainder interest, can be directed to the family foundation. Or, the family foundation may be established as the direct

beneficiary of a lifetime gift or of a gift at death. Generally, the foundation should be established and funded during lifetime, but occasionally the foundation is created at death under the terms of a last will or revocable trust.

The estate tax advantage of the family foundation is that 100% of the value of the donor's gift to the foundation is deductible. By judiciously using the foundation and split-interest trusts, the estate tax can be significantly reduced. Of course, the funds that go to the foundation must be used exclusively for charitable purposes — thus transferring money that otherwise would go to the federal government in the form of tax payments to a charitable vehicle that can be controlled by the family. Hence its name: “family” foundation.

#### *Donor Advised Funds and Supporting Organizations*

A donor advised fund is a specially named fund owned and controlled by a public charity but with respect to which the charity agrees to consult with the donor as to investments or uses (within the limitations of the charity's exempt purpose). A donor advised fund may accomplish the donor's objectives without the cost and administration expense of a private foundation. A donor advised fund may be established in relationship to a specific public charity or under the umbrella of a more broad-based charitable organization such as a community foundation.

A supporting organization is a separate organization similar to a private foundation except that it is limited to supporting a specific public charity. The family can be involved in the administration of the supporting organization but is generally not allowed to control it. The extent to which the supported organization is required to control the supporting organization is subject to complex rules. Because of these limitations, the supporting organization is not classified as a private foundation but rather is subject to the more liberal rules relating to public charities.