CHARITABLE GIVING

DISCLAIMER
This article is intended for informational purposes, only. It does not constitute legal advice. Nor is it a substitute for legal advice.

The purpose of this article is to describe in general terms some of the federal tax advantages of charitable giving, and to describe a few of the more common structures for making charitable gifts. Charitable giving plays a part in many estate plans, whether for the sole purpose of accomplishing charity, or to take advantage of the favorable tax treatment of charitable giving, or for a combination of these reasons.

There are transfer tax advantages in charitable giving, i.e. in the gift and estate tax treatment of charitable gifts. There are also important income tax advantages to charitable giving. These advantages reflect a policy to encourage charitable giving.

For estate and gift tax purposes, any amount given to a qualifying charity is deductible. So, for example, a person with a $7 million estate could transfer up to $5 million at the time of death to his or her heirs and transfer the balance to charity, thus avoiding the payment of estate tax. The charitable deduction for estate tax purposes is unlimited.

For income tax purposes, the deduction is not unlimited. This article will not explore all the convolutions of charitable giving income tax planning – that's for you and your accountant. Essentially, there are percentage limitations on the amount that a person may deduct from income tax for making gifts to charity. The limitations depend on a) whether one is giving to a private or public charity, b) the type of property that is being given away, and c) whether or not the donor is an individual or a corporation. In general, an individual may take a charitable deduction for income tax purposes of up to 50% of the donor's adjusted gross income.

Eligible Recipients
To whom may a gift be given charitably? In other words, what is a qualifying charity? Perhaps the easiest answer is to say that the IRS maintains a list of organizations eligible to receive tax deductible charitable contributions. That list can be found through the following website: http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.

Section 2055 of the Internal Revenue Code, pertaining to transfer tax charitable deduction, states that charitable contributions for transfer tax purposes include transfers:

- to or for the use of the United States, any State, any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

- to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports

competition (but only if no part of its activities involve the provision of athletic facilities or equipment), and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, which is not disqualified for tax exemption under section 501 (c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office;

- to a trustee or trustees, or a fraternal society, order, or association operating under the lodge system, but only if such contributions or gifts are to be used by such trustee or trustees, or by such fraternal society, order, or association, exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, such trust, fraternal society, order, or association would not be disqualified for tax exemption under section 501 (c)(3) by reason of attempting to influence legislation, and such trustee or trustees, or such fraternal society, order, or association, does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office;

- to or for the use of any veterans' organization incorporated by Act of Congress, or of its departments or local chapters or posts, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Charitable Giving

So, how does charitable giving take place for tax purposes? A charitable gift might be *outright* – a collection plate gift or a contribution to an alma mater's annual fund drive. Of course, that outright gift could also be a contribution of something very valuable. A gift can be of cash or of property, both tangible and intangible property.

If long-term capital gain property, such as land, is given to a charity, that charity may sell the property without paying capital gains tax on the appreciation. The donor would receive an income tax charitable deduction equal to the fair market value of the property at the time the gift is made.

Again, the income tax charitable deduction might be reduced depending on what kind of property is given, on the type of charity to which the property is given (private or public charity) and the percentage of gross income limitations.

A charitable contribution might also involve the gift of a *partial interest* in property. For example, a person might choose to give a parcel of agricultural land to charity but reserve a life estate for his or her spouse. Gifts of partial interest more commonly occur through the use of trusts, which typically provide more flexibility and advantages to the donor.

It is important to bear in mind that for a gift to qualify as a gift for tax purposes it must be completed. So, for example, for a person to give away a piece of land but keep a life

estate for himself is not a completed gift. To give someone ownership interests in a company but none of the income that goes with that ownership might not qualify for tax purposes as a completed gift.

This does not mean that a person cannot accomplish charity, and acquire the tax advantages of charitable giving, while still keeping some of the benefit of the property that is given away.[1] What follows is a discussion of some of the more common structures used to accomplish charity, retain a beneficial interest in the property that is given to charity, and realize some of the tax advantages of charity, all at the same time, so to speak.

<u>Charitable Lead Trust</u>
This is a structure under which the qualifying charity, the charitable beneficiary, receives an income or "lead" interest for a period of time after which the trust property, or some portion of it, that is, the remainder interest, will transfer to private beneficiaries, i.e. typically heirs and family of the donor. This type of trust allows a person to give to a charity, which will benefit for a period of time, with the property remaining in the family after the passage of that time.

Charitable lead trusts can be structured either as a charitable lead annuity trust or a charitable lead unitrust. The basic difference is that in an annuity trust the amount to be paid to the charity for the term of the trust is established from the start of the trust as either a fixed dollar amount or a fixed percentage of the net fair value of the trust assets. In a unitrust, a fixed percentage is to be paid to the charity but the net fair market value of the trust assets is determined annually for the term of the trust, and not at the inception of the trust.

A charitable lead trust can be set up during the lifetime of the donor or at the time of death. The charitable lead portion, i.e. the value of what the charity is to receive, represents a charitable deduction. It is more common, therefore, to structure the trust as an annuity trust as opposed to a unitrust, as this makes it simpler to value the respective portions of the trust assets as between the lead and remainder. For tax purposes, therefore, the lead portion represents a charitable deduction while the remainder portion represents a taxable transfer, either under the gift tax, if the trust is established during life, or under the estate tax, if the trust is established at the time-of-death. It is possible in some circumstances to structure the charitable lead trust so that no (or little) transfer tax, gift or estate, would be due as a result of the transfer of the remainder interest to family. How? The value of the remainder interest that will go to the family is computed by

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[1] In general, in order to obtain a charitable deduction the donor must part with all of a donor's interest in the property that is being donated. An exception to this rule arises under Internal Revenue Code Section 170(f)(3)(B)(i); a deduction is allowed for a contribution <u>not in trust</u> of an irrevocable remainder interest in a personal residence or farm. The exception does not apply where a trust is employed to hold the property during the life estate, which might present a surmountable obstacle in those cases where the would-be donor is using a revocable trust to hold his or her real estate. (I am not here talking about qualifying charitable trusts, such as remainder annuity or unitrusts.) It is also the case that to qualify for the deduction, the gift must be of the farm itself and not the proceeds of the sale of the farm, which would not presumably be an issue for New Generations

subtracting the value of the charitable lead interest from the full value of the trust assets. If the annuity is large enough, that is the lead interest paid to charity, and if it continues for a long enough period of time, the value of the annuity might equal the value of the asset.

As mentioned, the income tax aspects of charitable lead trust are beyond the scope of this article, but a very general description might be useful. The question: will the donor, the person placing the assets into the charitable lead trust, be able to take a charitable deduction for income tax purposes at the time of the transfer of property into trust? Yes, but only if the donor remains liable for the tax on the income amounts that are annually going to the charity. For many people, this might limit the attractiveness of the charitable lead trust. A brief example: Bob transfers $100,000 into a trust from which a $5000 payment will be made each year for nine years to his favorite charity. Bob will receive an immediate charitable deduction equal to the *present value* of the $45,000 ($5000 x 9) but only if Bob recognizes the annual $5000 for each of the nine years as his own income. The present value is determined using Internal Revenue Code actuarial tables, referred to as the 7520 Tables.

<u>Charitable Remainder Trusts</u>

A charitable remainder trust flips the order of beneficiaries from a lead trust. In other words, the charity receives the remainder portion of the trust and the income (or lead) portion goes to the private beneficiary. The private beneficiary would commonly (but not necessarily) be the donor, or the donor's spouse or the donor's children. The donor receives a charitable deduction for the value of the remainder interest if the trust is structured in certain ways, discussed below. As with the charitable lead trust, the remainder trust transfers can be structured to take place during the life of the donor or at the time death. If the transfer is made during life, the donor may receive a charitable deduction for income tax purposes equal to the present value of the remainder charitable interest. The private beneficiary who receives annual payments from the trust for its term generally must recognize those payments as income and pay tax on them.

Charitable Remainder Annuity Trust

In this trust a fixed amount is paid at least every year to the private beneficiary in an amount equal to no less than 5%, nor more than 50%, of the net fair market value of the trust assets. At the end of the term of the trust there must remain at least 10% of the initial net fair market value that will transfer to a charity or for a charity's use. No assets can be transferred into the trust after the initial funding. The term of the trust, the period over which the private beneficiaries will receive payments, must be measured either by the life or lives of the individual beneficiaries or by a period of years not to exceed 20. All beneficiaries have to be living at the time the trust is set up.

Charitable Remainder Unitrust

A unitrust requires that a fixed percentage of the net fair market value of the trust assets be distributed at least once a year to the private beneficiary. The percentage is fixed but the valuation of the trust assets occurs each year. Unlike the annuity trust, additional contributions to the unitrust trust can be made after the initial funding. The remainder

interest must go to a charity in an amount equal to no less than 10% of the net fair market value of the trust assets, valued as of the time of contribution. Like the annuity trust, the term is to be measured by the life or lives of individual beneficiaries (all of whom must be living when the trust is set up) or by a period of years not to exceed 20.

Payments to the private beneficiaries are typically made out of net income, and if that is not sufficient to meet the percentage requirement, then out of principal. However, a unitrust can be structured so that the annual payments are either in the fixed percentage amount or net trust income, which removes the possible need to sell trust assets to make annual payments. The trust might also contain a "make-up" provision under which any annual payments that falls short of the fixed percentage amount would have to be made up in later years. Such a provision can sometimes be used to defer income to the beneficiary until a time, such as retirement, when the income might be more useful or needed.

Pooled Income Fund

A person can receive a charitable deduction for making a contribution to a public charity's pooled income fund. The contribution is pooled with contributions from other people. The fund is maintained by the public charity. The donor retains a lifetime income interest with the remainder going to the public charity. The amount of the annual lifetime payments is determined each year based on the rate of return earned by the fund for the year. The charitable deduction is calculated by subtracting from the fair market value of the property transferred to the charity the present value of the lifetime income interest. That present value is determined using the 7520 actuarial tables.

Gift Annuities

This is another type of charitable remainder annuity trust. The donor gives a certain amount of money or property to a charity in return for the promise to make payments to the donor or other beneficiary for life. There can be no more than two beneficiaries. Payments received by the donor are taxable. There is a charitable deduction available for the value of the benefit to the charity. The annuity payout is often based on annuity rates recommended by the American Council on Gift Annuities. The published recommended rates as well as extensive information on gift annuities can be found at http://www.acga-web.org/.

Farm Land & Residences

In general, under our tax law, outside of the use of the trusts that have been discussed, a charitable deduction for income tax purposes is available to the donor only if the donor parts with (or transfers) all of the donor's interest in the property that is being donated. That is, the gift must be complete. There is an exception to this rule: under Internal Revenue Code Section 170(f)(3)(B)(i) a deduction is allowed for a contribution not in trust of an irrevocable remainder interest in a personal residence or farm. Such charitable transfer typically occurs under a life estate deed: the owner transfers the farmland or residence to a charity but retains a life estate, entitling the donor as life tenant to possess and control the property during his or her lifetime. (See separate article *Future Interests & The Life Estate Deed*.) Note the "not in trust" limitation. A potential donor who holds

title to his or her residence or farmland in a revocable trust will need to change that titling before embarking on such a charitable transfer, if he or she wishes to obtain a charitable deduction. (Transfers in trust that might qualify for the charitable income tax deduction are the lead and remainder trusts, as discussed above,) It is also the case that to qualify for the deduction, the gift must be of the farm or residence itself and not the proceeds of sale of the farm.

Conclusion

Charitable giving is favored under our tax code. Many of the tax rules that govern charitable giving are straightforward, such as the basic transfer tax rule that the charitable deduction for transfer tax purposes is unlimited, and the rule that you may in general take a deduction in income taxes for charitable gifts. However, a person contemplating making charitable gifts of a significant size should certainly seek professional advice. Many charitable organizations themselves offer guidance and information for making gifts in a tax-advantageous manner. Important considerations in making significant charitable gifts include deciding whether the gift should be made during life, at the time of death, or by the heirs after death. Finally, the tax advantages in making charitable gifts make it possible to structure those gifts in a way that benefits both the receiver and the giver. This is tax law in the service of altruism.

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