



FERRIS FINANCIAL, LLC

HELPING YOU PLAN, PROTECT & PROSPER



## Overview

The desire to assist a charitable organization must be a primary motive for making a gift; if no charitable inclination exists, charitable giving is difficult to justify. Alternatively, if a charitable motive exists, the tax laws provide various methods and incentives to encourage the donor's goodwill. The following summarizes the general rules applicable to charitable giving, including a discussion of some common strategies used.

## Tax Implications - Charitable Deduction Rules

Generally, charitable gifts can reduce federal income, gift, and/or estate tax. In addition, states that impose income and/or estate tax generally allow charitable deductions.

- ◆ An **Income Tax Deduction** is available for lifetime gifts to charity. The available deduction amount varies with:
  - The donor;
  - The type of charity;
  - The type of property donated;
  - The form of the gift; and
  - Whether the donor is an individual or a corporation.
- ◆ *Individuals to a public charity* (church, hospital, museum, university, etc.):
  - Cash is generally deductible up to 50% of the donor's Adjusted Gross Income (AGI).
  - Ordinary Income property or short-term capital gain property is deductible up to 50% of AGI; however, the deduction is limited to the lesser of the donor's cost basis or the property's fair market value on the date of the gift.
  - Long-term capital gain property is deductible up to 30% of the donor's AGI; alternatively, the donor can make a special election to deduct the cost basis up to 50% of AGI.
  - Gifts "for the use of" the charity are deductible up to 30% of AGI.
  - Note that partial interest gifts (i.e., those which are made into trust or which pay income only to the charity) may generate lower income tax deductions (discussed below).

- ◆ *Individuals* to a private foundation:
  - Cash is generally deductible up to 30% of the donor's AGI.
  - Ordinary income property or short-term capital gain property is deductible up to 30% of AGI.
  - Long-term capital gain property is generally deductible up to 20% of AGI.
  - Contributions in excess of the above AGI limits may generally be carried forward to future tax returns for up to five years. Upon death, the five-year carry forward dies with the decedent, but it can be claimed on the decedent's final income tax return.
- ◆ *Corporations* generally may deduct up to 10% of taxable income, with the five-year carry forward.

An **Estate Tax Deduction** is available for testamentary charitable gifts and is generally unlimited regardless of whether the recipient is a public charity or private foundation. However, partial interest gifts made at death are not eligible for a full deduction; only the present value of the charitable interest is deductible.

## Charitable Gifting Strategies

### ***Charitable Lead Trusts***

Charitable Lead Trusts are designed to provide an income flow to charity for a period of time, after which the donated property may be returned to the donor or distributed to other non-charity beneficiaries. CLTs are one of the few charitable giving techniques that can generate an income, gift, and estate tax deduction.

CLTs may be appropriate where a donor (i) has a desire to reduce income tax; (ii) owns an income-producing asset yet does not need the income currently; and (iii) would like to retain the asset principal or pass it on to other beneficiaries. A gift to a CLT is considered a gift "for the use of" (not a gift "to") charity, which reduces the income tax deduction to the private foundation limits discussed above.

Typically, these arrangements are used to transfer property to junior generation family members with little or no gift tax. Because the family member will not receive benefits from the property for a number of years, the value of the gift can be discounted substantially. Discounted value simply recognizes that a dollar to be received in the future is worth less than a dollar today.

### ***Charitable Remainder Trusts***

Gifts to a Charitable Remainder Trust (CRT) provide income to the donor for life or for a specified number of years, up to 20 years. At the end of the trust term, the charity receives the remainder of the property—somewhat the opposite of the Charitable Lead Trust. Contributions generate a current income tax deduction to the donor, based on the discounted value of the future gift to charity. The size of the deduction varies with the age of the taxpayer, the term of the payout, and the size of the annual payout in relation to the value of the donated property.

Low-basis securities or real estate often are attractive assets for such donations. The assets may pay little income to the donor, yet if he or she sells the asset, substantial capital gains would be due. However, if the assets are transferred to a CRT, they can be liquidated income tax-free since the CRT is a tax-exempt entity. The proceeds can be reinvested to provide increased income to the donor. The donor pays income tax only as the payments are received from the trust. It is important, however, that the donor transfer the assets to the CRT in advance of agreeing to sell the assets to a third party. A Charitable Remainder Annuity Trust (CRAT) is an arrangement in which property is donated in exchange for fixed annuity payments to the donor or the donor's designee. Annual payments must amount to at least 5% of the fair market value of the donated property at the time of the gift. If a fixed term (as opposed to a life term) is used, it cannot exceed 20 years. Additional contributions cannot be made after the initial funding.

A Charitable Remainder Unitrust (CRUT) is similar to a CRAT, but differs because the payout to the donor or designee may vary each year. The CRAT pays a fixed percentage of the original value of the trust assets, and the CRUT pays a percentage of the trust assets as revalued each year. CRUTs also allow additional contributions in subsequent years.

### ***Pooled Income Funds***

A pooled income fund is a type of trust created and managed by a charity, into which a donor transfers property. In return for the donation, the donor (or his designee) receives a lifetime income paid from the earnings of the fund. Note, if the donor names a designee other than himself as the income beneficiary, gift tax consequences may result. Upon the death of the income beneficiary, the value of the remainder interest is removed from the pooled income fund and transferred to the charity.

The donor will receive an income tax deduction in the amount equal to the present value of the charity's remainder interest (subject to public charity deduction limits). Factors determining present value include age of income beneficiary, value of the asset, and the highest rate of return of the fund over the last three years. The income beneficiary is taxed on the income received from the fund each year.

Pooled income funds are a good alternative where the donor would like a current income stream from donated property but does not want to incur the costs and legal fees of establishing a charitable remainder trust.

### ***Charitable Gift Annuities***

A charitable gift annuity is a direct contract between a charity and a donor, whereby the donor transfers cash or appreciated property to the charity in return for an unsecured promise to pay an income stream to the donor. The payment period can be measured by one annuitant's life (who is in most cases the donor) or by the lives of two joint and survivor annuitants (who are usually husband and wife). The donor receives an income tax deduction for the value of the property donated less the value of the gift annuity. The American Council on Gift Annuities publishes suggested charitable gift annuity rates for use by charities and donors.

Typically, payments are generally received as part non-taxable return of principal; part capital gain (in the case of appreciated property); and part ordinary income. Once principal and capital gain have been completely recovered by the payee, annuity payments are received as 100% ordinary income.

Charitable gift annuities are commonly used with smaller gifts to charities that have established gift annuity programs. A charitable gift annuity also may be appropriate where the donor wishes to increase cash flow from appreciated property that is not currently providing income.

Because annuity payments are not secured, the good faith and general assets of the charity are extremely important.

### ***Life Insurance Policies***

Life insurance can provide needed liquidity to fund gifts and endowments to a charity, and to replace value otherwise lost to heirs. Life insurance also can enable a donor to provide a more substantial contribution to charity than would otherwise be possible.

The simplest form of a charitable gift using life insurance is to designate a charity as beneficiary of the policy. At the donor's death, the estate will receive a charitable deduction equal to the death proceeds passing to charity. The donor retains the right to change the beneficiary and the right to the cash value of the policy during his or her lifetime.

A lifetime gift of an existing or new life insurance policy will generate an income tax deduction for the donor. The income tax deduction for a gift of a policy to a charity will be equal to the lesser of the donor's cost basis

in the policy or fair market value of the policy. The donor would then continue to make deductible charitable contributions equal to the annual premium on the policy. Deduction is subject to 50% limits for public charities and 30% for most private foundations. If the amount taken as a charitable deduction for the contribution of an existing policy to a charity is \$5,000 or greater, a qualified appraisal of the policy is required.

More often, life insurance is used as a wealth replacement device. Life insurance can replace some or all of a charitable gift by providing a cash gift to the donor's family. When placed into an irrevocable trust, the full amount of policy proceeds can pass, undiminished by estate tax, to the donor's heirs.

As with many other charitable planning techniques, the rules relating to the use of insurance for charitable giving can be complex and often encompass both state and federal laws. In particular, insurable interest laws, which vary from state to state, should be reviewed when charity-owned life insurance on a donor is considered.

### ***Private Foundations***

A private foundation (also called a "family foundation") is a charitable nonprofit organization established and funded by a single source, typically a donor family or corporation. The foundation is most often established during a donor's lifetime, but also can be created upon death. In essence, a private foundation is a tax-exempt checkbook; it is a repository of money and conduit between the donor and the charity. The private foundation itself does not directly engage in charitable activities (as compared with a private operating foundation, which has a stated charitable purpose and carries out its own programs, such as a food bank).

A private foundation is controlled by a board of directors or trustees, who may be selected by the donor. The board determines issues such as the charities to be benefitted, the size of grants, and investment policy. This enables the donor to involve family members early on in the decision-making process to foster philanthropy and social responsibility in future generations. Of all the charitable planning techniques available, private foundations provide the highest level of control and flexibility to the donor in terms of how gifts will be applied to charitable causes.

For lifetime cash contributions, the donor's deduction will generally be limited to 30% of AGI. For gifts of appreciated property, the deduction is generally limited to cost basis up to 20% of AGI. (Exception: deduction is not limited to basis for publicly traded securities where donated stock is no more than 10% of corporation's shares.) Unlike public charities, which are generally exempt from income tax, private foundations are subject to special excise taxes of up to 2% on investment income generated in a given year.

Because private foundations are considered more susceptible to possible operation for the private benefit of donors and managers, the Internal Revenue Code contains special rules for private foundations that do not apply to public charities. Violations will result in extremely severe penalties and taxes for the foundation, and in some cases, its managers and substantial contributors.

### ***Donor-Advised Funds***

A Donor-Advised Fund (DAF) is a separate account of a sponsoring charitable organization established by a donor who retains the right to recommend grants to be made to qualifying charities. The sponsoring organizations generally allow the donor to serve as an advisor to the fund or to name another person to serve as an advisor. DAFs are most commonly offered by community foundations that make grants to various local charities. In recent years, many established charities have begun offering DAFs in addition to their primary activities. Contributions to donor advised funds are generally eligible for a current income tax deduction.

A DAF is a good alternative to a private foundation due to lower costs associated with formation and management and fewer regulatory hassles. In addition, gifts to a DAF are subject to the higher deduction limits that apply to public charities – 50% for gifts of cash and 30% for gifts of appreciated property.

A DAF should be considered where the donor is interested in being involved in distribution decisions but is not making the larger scale gifts (\$5 million+) usually necessary to justify the expense of a private foundation. In addition, because the DAF can be established relatively quickly, it can be a very useful year-end tax planning tool. The donor can make an immediate donation and decide which charities to benefit later.

### ***Qualified Plans***

The use of retirement assets to fulfill charitable objectives has significant tax benefits. Generally, retirement plan proceeds are considered income in respect of a decedent (IRD); death beneficiaries receive proceeds as ordinary income (possibly taking an income tax deduction for the estate tax attributable to the IRD). However, IRD can be eliminated by naming a tax-exempt charity as plan beneficiary. Therefore, instead of the individual beneficiary keeping only a percentage of the plan dollars, charity can receive 100% of the plan.

In addition, the Protecting Americans from Tax Hikes ("PATH") Act of 2015 made permanent a provision that allows individuals over the age of 70½ to exclude from gross income up to \$100,000 that is paid directly from their IRA to a qualified charity. This Qualified Charitable Distribution can be used to satisfy any required minimum distribution that the individual must otherwise receive from their IRAs.

## **Additional Information about Charitable Gifting**

As with most tax incentives, the tax rules are complex, and it is important to obtain professional advice when making substantial charitable contributions. For example:

- ◆ The untaxed portion of appreciated capital gain property contributed to charity is treated as a tax preference item for alternative minimum tax purposes, which means, in effect, that for taxpayers subject to the alternative minimum tax, the income tax deduction is limited to the cost of the property.
- ◆ When gifting property that has been depreciated, the charitable deduction may be reduced.
- ◆ Contribution deductions arising from overvaluations of contributed property may result in tax penalties.
- ◆ For gifts of property valued at \$5,000 or greater, a qualified appraisal of the property is required.



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