

CHARITABLE PLANNING

# Charitable Planning Considerations

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## Threshold Issues

To ensure that the establishment and maintenance of a large charitable legacy is executed to maximum effect, the donor must generally take a significant and active role in the planning process. While charitable arrangements can offer significant income and estate tax benefits, effective implementation for both tax and non-tax aspects requires considerable deliberation and concerted planning.

### Initial questions to consider:

- Which charities are you currently supporting?
  - Do you wish to do more in the near term?
- Which charities would you consider supporting in the future?
- Does an endowment for a specific charitable entity or purpose appeal to you?
  - How much involvement do you wish to have? How much involvement do you expect your family to have in the future?
  - How much retained control should the family have?

Based on the answers to such questions, a focused and suitable approach can be developed that aligns with your objectives and planning thus far.

## Charitable Vehicles

### Public charity

The most familiar charitable beneficiary for most individuals, a public charity is a tax-exempt entity that performs the charitable function or otherwise exempt service. Examples include local or national charitable organizations, religious organizations, non-profit hospitals, and non-profit educational institutions.

### Donor advised fund (DAF)

Donor advised funds (DAFs) have increased in popularity in recent years. They are generally viewed as a more cost effective and less cumbersome option than private foundations for donors who seek immediate tax benefits on contributions but wish to have control over the ultimate charitable disposition of such gifts.

Additionally, long term capital gain property can generally be deducted at fair market value for DAFs, whereas deductions may be limited to basis if donated to a foundation.

General mechanics:

- A fund is established with a local charitable fund or community foundation, and the family “advises” as to what charities to benefit.
- While the donor does not have complete control, he has significant influence.
- Assets maintained in the tax-exempt fund can generally avoid income tax on any earnings, enhancing the long-term benefits for the charity.

An endowment for a specific charitable goal may be established through a DAF, while the ability to select which charities are utilized to fulfill such goal may be modified as circumstances warrant.

## Private foundation

For large estate owners interested in being involved in the charitable process on an ongoing basis, private foundations offer the opportunity to, in essence, establish a tax-exempt check book. Assets in the foundation can then generally be invested with tax-exempt returns. On an annual basis, at least 5% of foundation assets must be granted to an eligible charitable organization.

Foundation planning enables a family to gradually gain familiarity with charitable endeavors and opportunities over time. Such a vehicle is also an excellent way to get the next generation involved in planning at an early stage.

By continuous and ongoing family involvement, your values and charitable goals can be passed on to the next generation, ensuring that your charitable vision and mission is accomplished in a highly personal fashion. Without heavy involvement and direction by the founder, a foundation may languish in the hands of disinterested relatives, with charitable bequests made in an ad-hoc fashion, possibly contrary to the wishes of the primary funder.

## Income Tax Considerations

### Income tax deduction limits for charitable contributions

It is important to note that the deductibility of charitable gifts is dependent on both the nature of the asset contributed and the character of the charitable recipient, as shown below.

| Type of Property Contributed               | Public Charity  |                   | Private Foundation |                   |
|--|-----------------|-------------------|--------------------|-------------------|
|  | Deduction Value | Percentage Limit* | Deduction Value    | Percentage Limit* |
| Cash                                       | Cost            | 60%               | Cost               | 30%               |
| Ordinary income property                   | Cost            | 50%               | Cost               | 30%               |
| Short-term capital gain property           | Cost            | 50%               | Cost               | 30%               |
| Long-term capital gain property            |                 |                   |                    |                   |
| General rule                               | FMV             | 30%               | Cost               | 20%               |
| Donor elects reduced deduction             | Cost            | 50%               | N/A                |                   |
| Qualified appreciated stock**              | N/A             |                   | FMV                | 20%               |
| Tangible personal property – unrelated use | Cost            | 50%               | Cost               | 20%               |

\* Extent to which contribution may be deductible based on donor's adjusted gross income (unused deductions may generally be carried forward for additional 5 years).

\*\* Generally consists of publicly traded stock.

Note: Donor advised funds and private operating foundations are generally considered public charities for purposes of these rules.

### Other income tax considerations for certain assets

#### *Contribution of appreciated assets*

Rather than contributing cash to a charity, gifts of appreciated assets may be more tax efficient. Donations of appreciated property to a public charity can generally be deducted at fair market value, avoiding taxation on the gain to the donor.

#### *Retirement accounts at death to charity*

Generally, retirement plan proceeds are considered income in respect of a decedent (IRD); 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.

## Conservation easements

Contributions involving real property for conservation purposes can permit you to retain use and enjoyment of the property while preserving certain aspects of the property.

For example, a conservation easement is an agreement between a landowner and another (public) party that restricts development on a tract of land. If the easement is held by a qualified government entity for valid conservation purposes (e.g., public recreation, protection of a natural habitat, preservation of open space, etc.) it may provide federal and state tax benefits. An income tax deduction of up to 50% of adjusted gross income may be available, with a 15-year carryover.

Estate tax values may decrease as well to reflect the restrictions on the property. Property taxes also may decrease to reflect lower fair market value.

General mechanics:

- A state or local conservation trust is contacted to determine the viability of a conservation easement for both you and the agency.
- A legal agreement is executed by the parties restricting the use, development, or modification of the property as appropriate into perpetuity.
- A professional appraisal would be obtained to substantiate the diminution in value of the property as a result of the restriction, which would then be deductible.

A recent IRS Notice may limit the effectiveness of this planning technique, so please consult with a tax advisor.

## Split interest charitable trust arrangements:

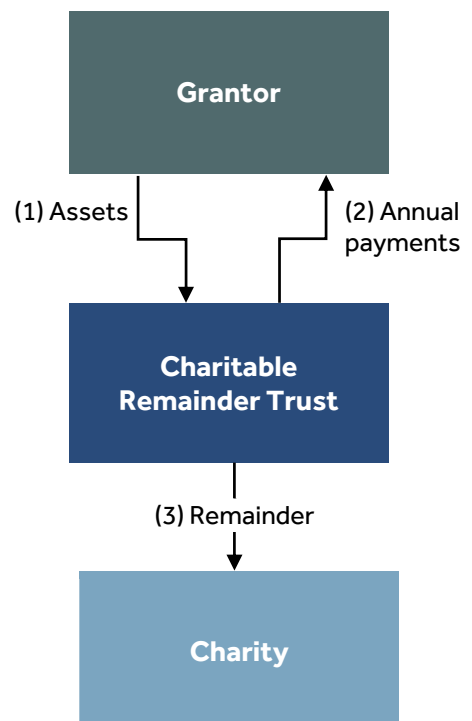
Split interest charitable trust arrangements also can offer the ability to effectively divide interests in property between charitable and non-charitable beneficiaries in an income tax efficient fashion.

### *Charitable Remainder Trust (CRT)*

A CRT permits you to convert appreciated property into income-producing assets for your benefit without triggering immediate income tax, while also benefiting a specific charity or foundation.

Mechanics:

- (1) First, you would establish a trust and fund it with assets, taking a charitable income tax deduction for the actuarial value of the charity's future interest.
  - The deduction limits for the donor are generally based on the character of the remainder beneficiary charity (e.g., public charity, DAF, foundation).
- (2) In turn, the trust would pay you an annual income—a percentage of the trust's assets – generally between 5% and 10%.
  - To generate your annual payout, the tax-exempt trust would typically sell the property, and invest in assets that produce a regular income.
  - The CRT is a tax-exempt trust; therefore, no tax is triggered at the time of the sale.
  - You would pay income tax only when you receive your annual payments.
- (3) At the end of your life (or term of years), any balance left in the trust would pass to the charitable recipient.



Payments can be structured as either a fixed percentage of the value of the CRT at inception (an annuity trust, or CRAT), or a fixed percentage of the value of the CRT assets on an annual basis (unitrust, or CRUT).

Charitable remainder trusts are primarily employed to mitigate the income tax on a planned sale of highly appreciated property (however, the current low interest rate environment makes CRTs less attractive for income tax planning).

### *Charitable Lead Trust*

A charitable lead trust (CLT) is essentially the reverse of a CRT. Such a vehicle can:

- Enable you to benefit charity today;
- Benefit your family later; and
- Permit a charitable income tax deduction for the charity's actuarial interest.

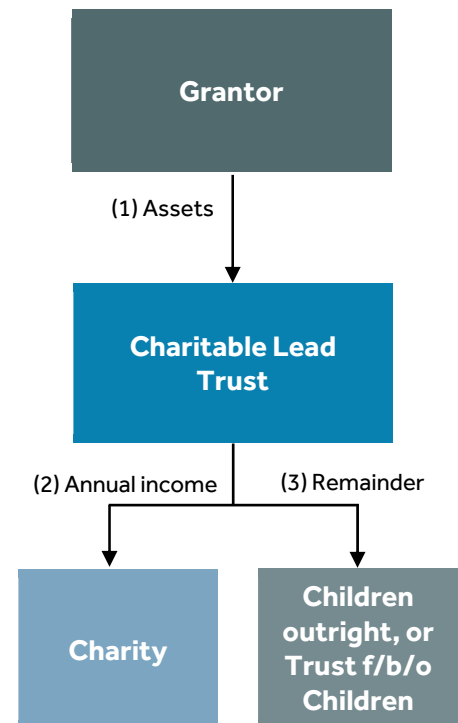
### **Mechanics:**

- (1) First, you would establish a trust and select assets to fund the trust.
- (2) Next, determine annual income amount to be paid to the charity.
  - Based on the size of the payout structured to go to charity and the duration, the remainder value for heirs is generally reduced to zero, resulting in little or no taxable gift.
    - The trust may be structured to either generate a current income tax deduction for the charity's actuarial interest, but subsequent trust income will be taxable to the donor (Grantor CLT).
    - Conversely, the trust can be structured to permit the trust to take a deduction against trust income for annual charitable contributions (Non-Grantor CLT).
- (3) After the term of years, the remaining assets would pass to your heirs (or more likely, a continuing trust for their benefit).

As with a CRT, a CLT can be designed with fixed annuity (CLAT) or unitrust (CRUT) payments.

Because of the ability to shift wealth at a significantly reduced gift tax value, a CLT may be an attractive option to unwind the private split dollar arrangements currently employed to fund your irrevocable life insurance trusts (ILITs).

One disadvantage for CLT wealth shifting, though, is that effective generation skipping transfer (GST) tax planning is generally not feasible. As such, any GST planning contemplated through your ILITs should be reviewed in conjunction with possible wealth shifting options.



## **Coordination with Estate Tax and Wealth Distribution Planning**

The above-described charitable planning techniques also can be employed in conjunction with your estate plan.

### **Bequests at death**

The simplest route is frequently to make bequests of pecuniary amounts or certain percentages of your estate directly to charitable beneficiaries. Such bequests are generally estate tax deductible; however, the deductibility of split interest trusts will depend on the value of the charity's interest at that time in light of the current interest rate environment.

Identifying which assets are most appropriate for bequests is also an important consideration. Liquid (or easily converted to liquid) is generally preferred. Closely held business/real estate/investment entity interests may be less desirable as a bequest. Additionally, there may be restrictions in place regarding ownership/transfers, etc.

There also are limits and restrictions on vehicles that can be utilized for certain assets. For example, a CRT cannot own shares of an S corporation; certain entities may generate taxable income for the charitable entity.

### Contribution from surviving spouse

Rather than making a bequest from the estate, a contribution from assets left to a surviving spouse may offer additional income tax benefits.

A charitable bequest from the estate may be eligible to offset an estate's taxable income; however, that deduction may be much better utilized by the surviving spouse. A bequest made in this fashion is effectively estate tax deductible as well.

Two issues generally arise, though:

- Can my spouse afford such bequest?
  - Requires a determination of sufficient liquidity and income resources.
- Can my spouse be required to make such bequest?
  - The contribution must be at the sole discretion of the spouse, from property of which the spouse generally has unfettered access.

### Charitable Remainder Trust at death

While not frequently employed, a CRT can be a vehicle for bequests at death to provide a stream of income to family members, while leaving the balance of assets to charity. As a tax-exempt, the trust assets can enjoy higher appreciation rates. Payments to non-charitable beneficiaries, of course, carry out deferred trust income. The value of the estate tax deduction for the bequest is based on the charity's actuarial interest.

### Charitable Lead Trust at death

A CLT is frequently employed to reduce or eliminate the estate tax on assets passing to heirs. For example, under a "Zero Estate Tax Plan," a charitable lead annuity trust (CLAT) is funded with some or all of the taxable estate (above available estate tax exemptions) and made payable to charity for a term of years, with balance of trust assets continuing for the benefit of family.

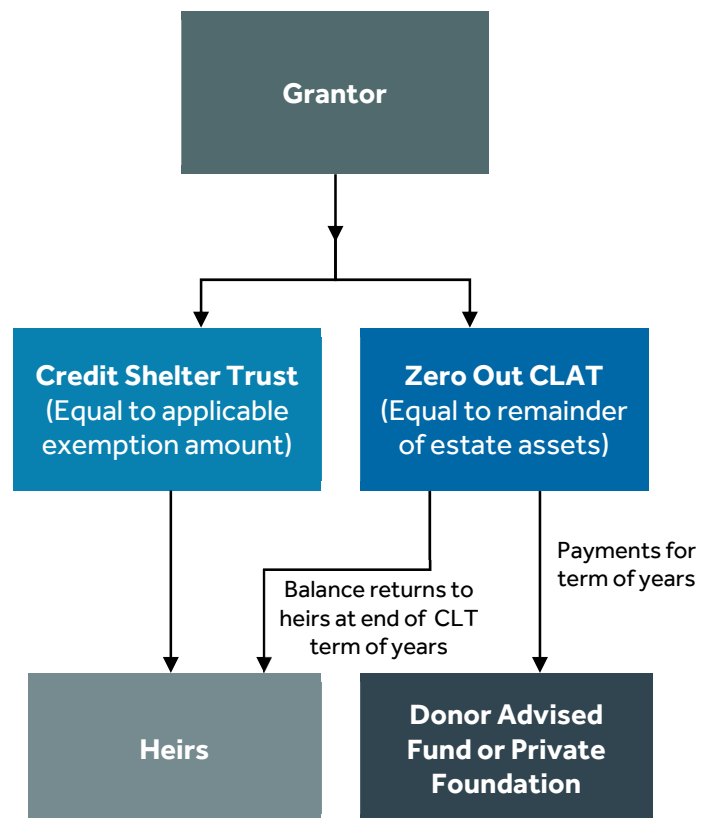
The mechanics of using a CLT at death are illustrated at right.

#### *Potential drawbacks of zero-out tax plan*

You may not wish to leave additional assets to heirs through a CLT. Furthermore, any such heirs may likely be in subsequent generations—as described above, a CLT is not generally effective for GST tax planning. As a result, assets passing to further heirs may still incur GST tax.

#### *Health and Education Exemption Trust (HEET) as remainder beneficiary of CLT*

To address the above drawbacks, a specialized health and education exemption trust may be the ultimate remainder beneficiary of the CLT. A HEET is a long-term trust for the





limited purpose of health and education, as defined under Internal Revenue Code Section 2503(e), for the benefit of grandchildren or more remote descendants.

HEET trusts generally should include a charitable beneficiary, with an interest that is both mandatory and significant. For example, a mandatory interest may be a unitrust percentage of the trust value or trust income. The charity also is generally given an indefinite interest such as a discretionary interest in addition to the mandatory interest.

Distributions must be made to the education or medical provider directly as required under IRC §2642(c)(3) and IRC §2503(e). Other distributions may be permitted, but any non-2503(e) distributions to skip persons would be subject to GST tax. The trust can specify preference or priority among beneficiaries and/or generations.

Where leaving vast sums to distant heirs may be unattractive, a HEET may offer the option of funding, in an estate tax efficient fashion, a family health, scholarship, and charitable fund. This could help alleviate concerns over the significant and increasing costs of higher education and concerns over debt that may otherwise limit an individual's access or opportunity. Future costs of medical services and insurance may also affect the availability and quality of healthcare.

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