Charitable Giving 101

Presented by:

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Basics of Planned Giving

- What is a "qualified charity?"
- What assets can one gift to a qualified charity?
- What are the income, estate, and gift tax deductions available?
- What are the different types of charitable giving methods?

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What is a "Qualified Charity"

- Charitable Purposes
  - Ordinary meaning is relief of poor
  - Legal Definition
    - "Function to promote the general welfare that is not violative of public policy"[1]

[1] See Bruce R. Hopkins, The Law of Tax Exempt Organizations

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What is a “Qualified Charity”

Organizations that meet the requirements of Internal Revenue Code section 501(c)(3) are exempt from federal income tax as *charitable organizations*. In In addition, contributions made to charitable organizations by individuals and corporations are deductible under Code section 170.

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What is a "Qualified Charity"

- Every exempt charitable organization is classified as either a *public charity* or a *private foundation*.
- Life Cycle of public charity and private foundation on IRS.gov

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What is a “Qualified Charity”

- How to Form (State law)
  - Nonprofit Corporation
  - Charitable Trust
  - Unincorporated Association
- Application for Recognition of Exemption (Form 1023)
  - Public Disclosure requirements

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What is a “Qualified Charity”

- Annual Filing requirements
  - Form 990
  - Form 990 PF
  - Employment taxes
- Limits on Activities
  - Political Activities
  - Lobbying Activities
  - Unrelated Business Taxable Income (UBTI)
  - Jeopardizing Investments

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Charitable Gift Assets

- Types of Assets
- Appropriateness of Assets
- How to transfer the Assets

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What Assets Should One Gift?

- Cash
- Publicly Traded Stock
- Closely Held Stock
- S Corp Stock
- LLC interests
- Corporate Bonds
- ESOPs
- Retirement Plans
- Ordinary Income Assets
- Government Securities
- Savings Bonds
- Partnership Interests
- Installment Obligations
- Royalties
- Mineral Interests
- Tangible Personal Property
- Real Property
- Capital Gain Assets

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Donor Benefit

- Charitable contributions are generally deductible if the organization is exempt under IRC 501(c)(3)
  - Publication 78 from IRS.gov

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Donor Benefit

Charitable organizations—this category consists of the following:

(a) religious;

(b) charitable;

(c) scientific;

(d) literary;

(e) educational;

(f) fostering national or international amateur sports competition; or

(g) for the prevention of cruelty to children or animals;

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Donor Benefit

Charitable organizations—includes:

- Governmental bodies,
- War veterans organizations
- Domestic fraternal lodges, or
- Cemetery organizations

See IRC 170(c)

Donor Benefit

Depending on the particular category, the deduction *may not* be permitted if the recipient isn't a domestic organization, with exclusively qualifying purposes, or if it fails to meet the inurement, legislative activities, political activities or certain other restrictions.

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Donor Benefit

A contribution qualifies as a charitable contribution only if it's made either *to,* or *for the use of,* an organization

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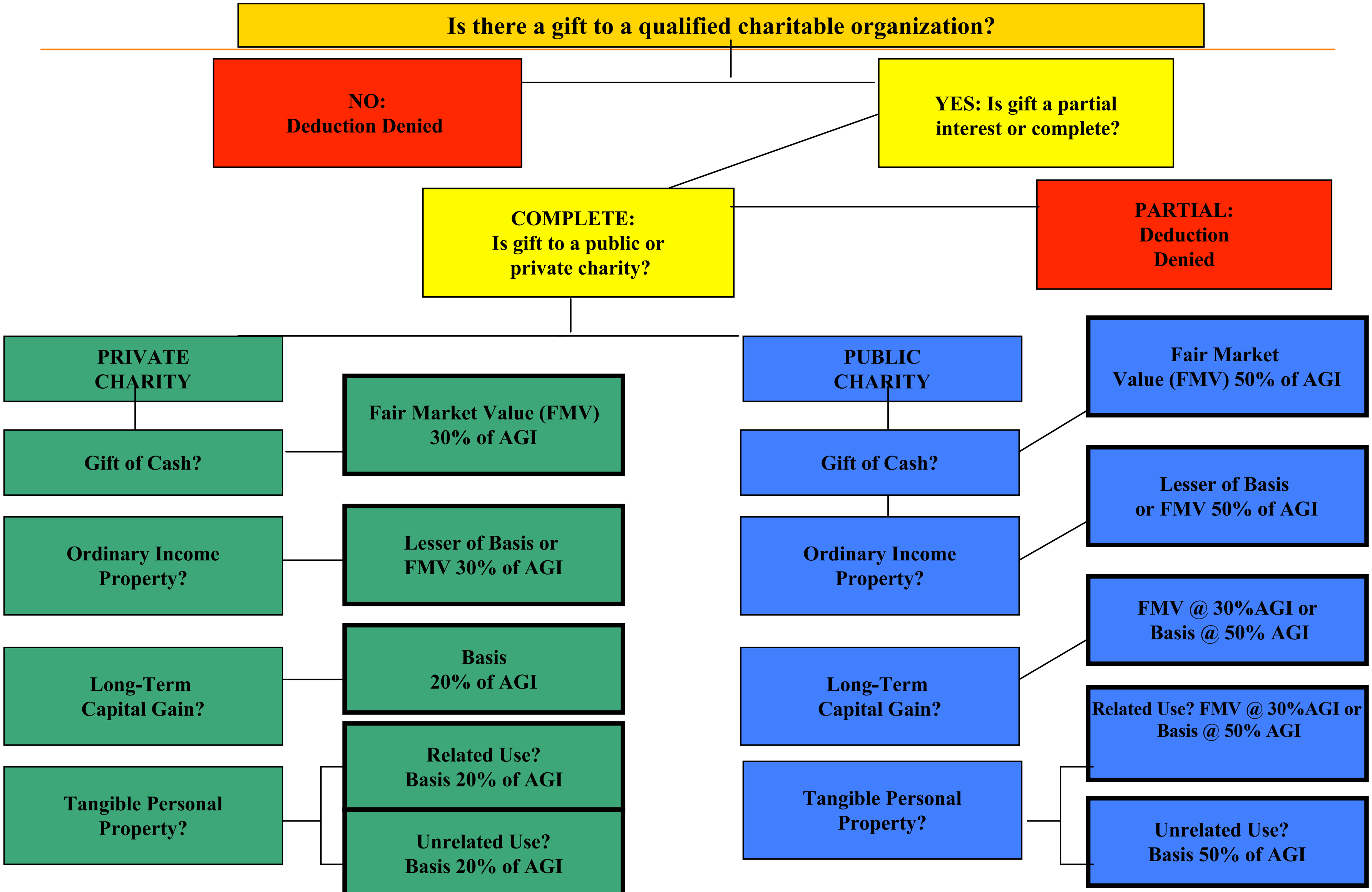
Summary of Income Tax Treatment of Charitable Donations



Income Tax Deduction

- Limited by the donor's adjusted gross income (AGI)
- If the transfer is contingent or conditional, special rules may apply to tax deductions

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Gift Tax Deduction

Gifts to qualified charitable and similar organizations are not subject to gift tax

- Such gifts are deducted in computing the amount of taxable gifts

If the transfer is contingent or conditional, special rules may apply to tax deductions

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Estate Tax Deduction

The estate tax charitable deduction is allowed for the value of property included in a decedent's estate, if:

- The property is transferred to a qualified charity or for qualified charitable purpose
- The property passes from the decedent during life or by will

If the transfer is contingent or conditional, special rules may apply to tax deductions

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Charitable Giving Methods

- Outright Gifts
- Testamentary Gifts
- Bargain Sale
- Split Interest Gifts
- Remainder Interests
- Private Foundations & Alternatives
- Life Insurance

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Outright Gifts

- A gift of cash or property during life creates:
  - Current Income Tax Deduction
  - Loss of Wealth

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Testamentary Gifts

- Donor Gifts Property Pursuant to His/Her Will
  - Reduces Total Estate Subject to Estate Tax
  - Reduces Amount of Wealth Transferred to Heirs

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Bargain Sale

- Occurs when an individual transfers an asset to charity and receives less than the fair market value in return

- The donor will benefit from the bypass of gain and receive a charitable deduction on the gift portion, but must recognize taxable gain on the value returned to him or her

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Split Interest Gifts

- Charitable Gift Annuities
- Pooled Income Funds
- Charitable Remainder Trusts
- Charitable Lead Trusts

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Charitable Gift Annuity

- Annuity agreement is created between the donor and the charity
- Donor transfers asset to Charity in exchange for Charity's agreement to pay donor or donor and spouse a lifetime annuity
- The Donor:
  – Receives an income tax deduction for gift
  – Defers Capital Gain, if applicable

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Charitable Gift Annuity

- The donor:
  - Receives an income tax deduction for gift
  - Defers Capital Gain, if applicable

- BUT:
  - Annuity payments are <u>NOT GUARANTEED</u>

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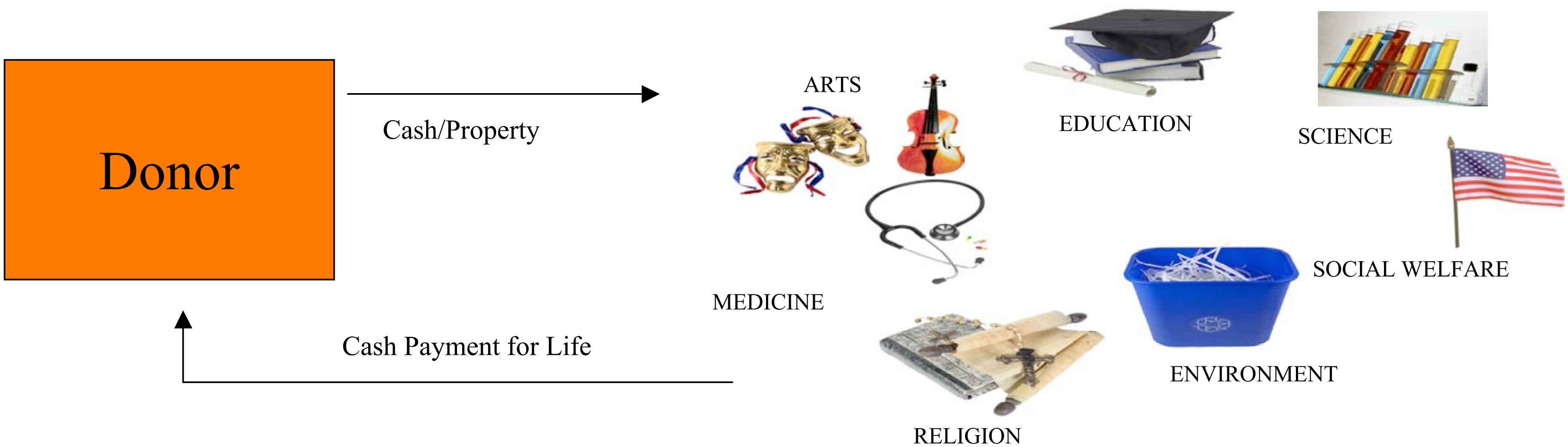
Charitable Gift Annuities

Cash or other property is given to a charity in exchange for the charity's promise to pay a fixed amount to the donor or other annuitant for life or some other specified period of time. The Charity's promise takes the form of an annuity.



How it Works

1) Donor transfers cash or other property. 2) Charity executes an annuity agreement promising to pay the Donor (or other designated person) an annuity for life. 3) The amount of each annuity payment depends upon the amount of property transferred and the annuity rate. 4) The American Council of Gift Annuities publishes rates from time to time that are the primary source of rates used. These rates assume a gift of 50% to the charity. As an alternative the charity can establish the rate. 5) There may be a charitable deduction during the first year. 6) The payment may be subject to tax

Pooled Income Fund

- A trust fund is maintained by the Charity
- One or more donors donate assets to the fund maintained by the Charity
- Donor (or another) retain an income interest from the fund
- Upon the death of the last donor, the fund is paid to the charity

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Charitable Remainder Trust

- Trust is tax-exempt
- A trust designed to pay annual income to one or more non-charitable beneficiaries for a term of years or for the lifetime of one or more individuals
- Upon expiration of the income term, assets revert to a charitable beneficiary

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Charitable Remainder Trust

- Donor who creates a charitable remainder trust:
  - Receives a charitable deduction for the gift to charity
  - Defers capital gain, if applicable

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Charitable Remainder Trust

- Two types of Charitable Remainder Trusts:
  - Charitable Remainder Annuity Trust
  - Charitable Remainder Unitrust

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Charitable Remainder Annuity Trust (CRAT)

- Annual payments from trust are fixed at the time the trust is created
- No additional contributions may be made to trust
- Annuity payments can not be less than 5% nor more than 50% of trust's initial Fair Market Value (FMV)

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Charitable Remainder Unitrust

- Annual payments from trust fluctuate as the trust's value fluctuates
- Additional contributions are permissible
- Donor's annuity payments can not be less than 5% nor more than 50% of trust's initial FMV

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Charitable Remainder Unitrust - Hypothetical Example

Irrevocable Trust

Donors

Donors contribute $300,000 of property

Trustee

Donors receive $18,000 per year
for life and may receive a
$75,954 deduction in year 1. [1]

Education

Medicine

Religion

Property: $300,000

Charity Receives property
after both lives

Remainder (Death in
Year 27): $360,720

Assumptions:

The property in the trust grows at 7%. The 7520 rate is at 5.6%. The payout percentage is 6%. Donors are age 65 and 62.

[1] Capital gain is recognized on the contributed property only when distributed each year.

Derivatives of the Charitable Remainder Unitrust

– Net Income Charitable Remainder Unitrust (NICRUT) - Pays the lesser of the stated percentage of the trust's annual value or income earned

– Net Income with Make-up Charitable Remainder Unitrust (NIMCRUT) - Pays the lesser of the stated percentage of the trust's annual value or income earned BUT can "make-up" deficiencies from prior years by paying out excess income

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Deductions CRTs

- Generated Deduction for Gift to Trust:
  - Equals the present value of the remainder interest which eventually will go to the charity
- Permitted Deduction for Gift to Trust:
  - Amount of "Generated Deduction" the donor can recognize depends on the following factors:
    - Amount of Donor's Adjusted Gross Income in the year of the gift
    - Type of Charity
    - Type of Gift

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Taxation CRTs

- Distributions from the CRT taxed under a “four tier” system
- Under “four tier” system, trust is deemed to distribute annuity or unitrust payment in the following order:
  - Ordinary Income
  - Capital Gains
  - Tax-Exempt Income
  - Return of Principal

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Charitable Lead Trust

- A trust designed to pay annual income to one or more charitable beneficiaries for a term of years or for the lifetime of one or more individuals
- Upon expiration of the income term, assets revert to a non-charitable beneficiary

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Charitable Lead Trust (CLT)

- Donor who creates a charitable lead trust:
  - Receives an income tax charitable deduction if the donor is taxed on the income of the trust under the grantor trust rules
  - Leverages gift tax exposure of assets passing to heirs if a non-grantor trust is used
  - Wants assets to ultimately remain “in the family”

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Charitable Lead Trust *(Grantor)*

In Trust

Donors

Donor contributes $300,000 of property

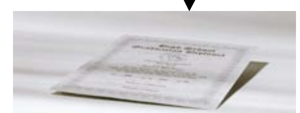
Trustee

Donor may receive an **income** tax deduction in year 1. [1]

Taxable gift of $164,971 received by family at the end of ten years

Charity receives $18,000 per year for ten years.

Family



Receives property after ten years

Charity

Assumptions:
The property in the trust grows at 7%. The 7520 rate is at 5.6%. The payout percentage is 6%.

[1] This trust is structured as a grantor trust. All income from the trust is taxable to the grantor even though it is paid to the charity.

This is a hypothetical example and is not intended to a projection of future values. Rates of return will vary over time, particularly for long-term investments. Investments offering the potential for higher rates of return also involve a higher degree of risk. Individual results will vary.

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CRT and CLT Administrative Issues

- Choice of Trustee
- Valuation
- Sale of Assets
  - Donative Intent
  - Step-Transactions
- Private Foundation Rules
- Tax Returns

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Pooled Income Fund

- The donor:
  - Receives income tax deduction for gift
  - Defers capital gain, if applicable
- BUT:
  - payments are <u>NOT GUARANTEED</u>

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Remainder Interests

- Transfers from a taxable estate will qualify for an estate tax charitable deduction, so long as they benefit a qualified exempt charity or the entity is "operated exclusively for religious, charitable, scientific, literary or educational purposes." Sec. 2055(a)(2)
- In order to receive a deduction, the right of the charity must be vested

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Private Foundations

- Private Foundation
  - Not-for-profit entity that can be controlled by a person, family or business
  - Organized exclusively for charitable, educational, religious, scientific and literary purposes under IRC 501(c)(3)
  - The foundation must be officially recognized by the IRS in order for contributions to be tax deductible

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Benefits of a Private Foundation

- Family legacy
- Control
- Family involvement
- Current tax deduction for future grants

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Disadvantages of a Private Foundation

- Heavy Regulatory Control
  - Self Dealing
  - Private Inurement
  - Jeopardizing Investments
  - Unrelated Business Taxable Income
  - Minimum Required Distributions
  - Excise Taxes
  - Grants made to only public charities

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Private Foundation – Tax Deduction

- Typically, donations to a private foundation are tax deductible up to:
  - 30% of adjusted gross income (AGI)
  - 20% of adjusted gross income
  - Five-year carry forward

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Private Foundation Alternatives

Alternatives

- Donor Advised Funds
- Supporting Organizations

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Private Foundation Alternatives

- Generally, both DAFs and SOs avoid the private foundation rules
  - Higher limitation on the income tax deduction
- Recent changes by the Pension Protection Act (PPA)

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Donor Advised Fund (DAF)

- Separate fund created by a 501(c)(3)
  - Contributions received from an individual, family or small donor group
  - Contributions are set apart for a fund
- Donor “advises” the donee regarding the use of the gift
  - Donee must have ultimate decision-making authority over the gift

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Donor Advised Funds

- Excise Taxes
- Form 990
  - Disclosure by sponsoring organizations
- IRC 508
  - Organization cannot be recognized as having 501(c)(3) status unless it applies to IRS

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Supporting Organizations (SOs)

- Three types
  - Organizations that are "operated, supervised, or controlled by" one or more publicly supported organizations ("Type I")
- Organizations that are "supervised, or controlled in connection with," one or more publicly supported organizations ("Type II")
- Organizations that are "operated in connection with" one or more publicly supported organizations ("Type III")

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Supporting Organizations

- Type III SOs

  ** A February 22 IRS memo says that until guidance is published the IRS will stop issuing determination letters under section 509(a)(3) for organizations seeking classification as functionally integrated Type III supporting organizations **

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Summary

- Determine the goal(s) of the client
  - Charitable Deduction
  - Control
  - Etc
- Determine the best method to meet the client's goal(s)
  - Public donation
  - Split Interest Gift
  - Private Foundation
- Determine any regulatory issues

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Questions

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