GO TAX FREE FOR A CHARITY

Selection from the book

ABSTRACT

Donating money feels good and aligns your income and assets with a cause you feel passionate about. It creates legacy benefits by removing the asset from your taxable estate. Donations can eliminate taxes on a highly appreciated asset, like a business or a farm. Plus, you get recognition for making a large gift while you are alive, for instance, by endowing a chair at your alma mater.

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Go Tax Free for a Charity

Absolute: The federal government rewards certain behaviors with tax incentives. We can take advantage of these rewards.

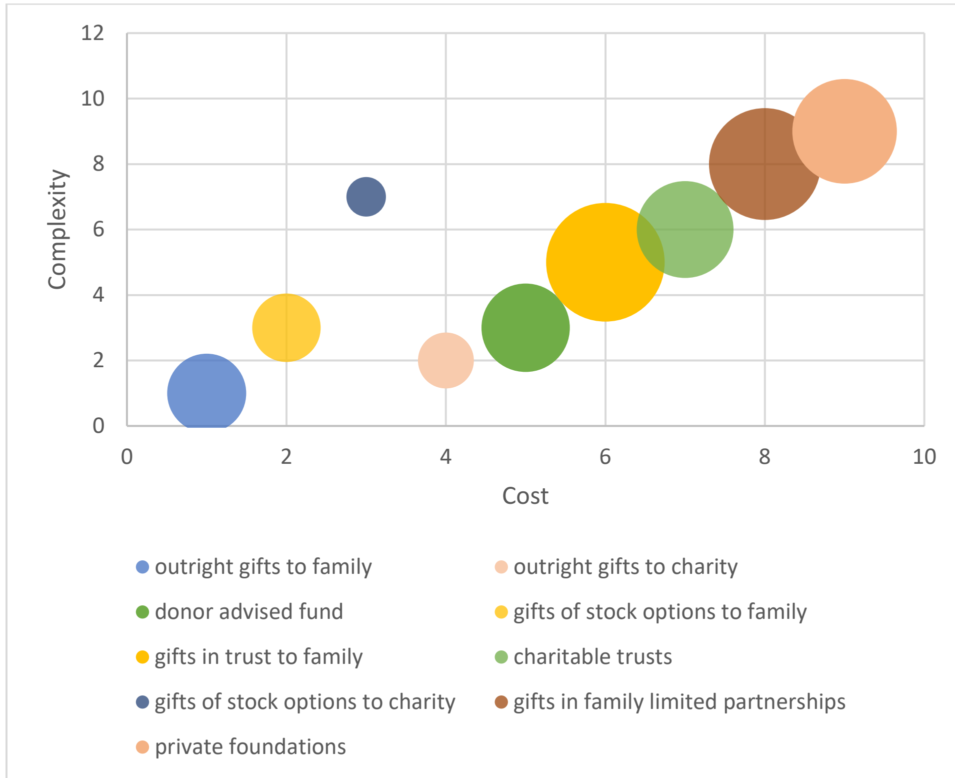
Bill and Linda worked at large corporations for many years. They believe in saving and not spending more than they earn. Now they have quit the corporate life and would like to save some of their assets from the taxes, passing on their wealth to their children, grandchildren, and church. They enlist the help of an attorney and financial planner and create a charitable remainder trust as well as a wealth replacement trust to accomplish their goals. They enjoy a tax-deductible charitable donation, avoiding taxes on the gains of their investments, and they generate income for both of their lives. They are proud of the gifts they have made to their heirs and their church.

Forms of Charitable Planning

Charitable planning can take many forms. Some plans are simple, some complex. Some plans are expensive and others are nearly free (other than the gift itself). And some charitable plans take on some risk while others are completely safe.

- Outright gifts to family
- Outright gifts to charity
- Donor advised fund
- Gifts of stock options to family
- Gifts in trust to family
- Charitable trusts
- Gifts of stock options to charity
- Gifts in family limited partnerships
- Private foundations

The following illustration shows these various methods of gifting and sorts them by complexity and cost. The size of the bubble indicates the relative safety. Note that this illustration is on a relative basis. Each plan stands relative to each other plan, no "ties" allowed. Just because it is a large bubble does not mean it is not safe: nor does a "cost" other than "zero" mean that a particular plan absolutely has a cost—your particular charitable may not have a cost at all.



Outright gifts

Outright gifts to family members and to charities are the most easy to understand. The donor writes a check, in many instances. You may also give tangible items, like jewelry or artwork. You may give securities like stocks or bonds. You may gift a partial ownership of a business or real estate property. The outright gift to a charity generally allows you to receive a charitable deduction, as long as the charity follows the strict federal rules.

Large charities, registered with the Federal government, enable you to make larger tax-deductible donations than small charities. Recently the rules changed around the percentage of your "Adjusted Gross Income" that was tax-deductible for charitable giving purposes. For the most recent tax rates, refer to www.gotaxfreebook.com

Gifts to family members and other natural persons are not tax-deductible. However, you may make a gift to your relatives for the purpose of attending college. Generally speaking, a 529 college savings plan or a gift directly to the school is the best, simplest, least-expensive way to make a tax-advantaged gift for education.

You may want to help a child or grandchild, or other important person in your life, buy a home or make another large purchase (a wedding perhaps?). In this case, the tax benefits of direct gifting are null. Sometimes these are the reasons to consider more complicated plans, like trusts, discussed hereafter.

Gifts of Equities and Stock Options

Equities and stock options are often awarded by companies to top performers, and executives, in lieu of (or in addition to) a salary or bonus. Equity in the company aligns the employees with shareholders, rewarding them for increased share value.

Stock options are popular for many reasons, not the least of which are the tax advantages. Options are not taxed until they are exercised—and turned into regular shares of stock. The tax benefits of options may be substantial, depending upon the unique situation of the owner. On the other hand, options can sometimes be tax-expensive if the "cost basis" is very low.

A gift of stock options to a tax exempt charity, with no tax obligations at all, can be a very large gift indeed. And a gift of stock options to a grandchild who is in a very low taxable income bracket could also be a meaningful gift.

Let's take a look at the math. If $1,000 of net gain were to be exercised at a 40% income tax bracket, the donor could make a $600 gift to her grandchild or charity. But if she were to give it directly to the charity, the charity would receive and could spend all $1,000. Plus, the donor receives a tax deduction for the same $1,000, saving her $400 in taxes she otherwise would have paid.

The previous example shows a high tax bracket. Sometimes equities and stock options are taxed as a long-term capital gain and not taxed at the higher income tax rates. Regardless, the math remains the same. A gift of an appreciated asset, like equities or options, provides more benefits for the giver and the charity than does a direct gift, after-tax.

Similarly, if a donor makes a $1,000 gift of equities or options to a natural person, usually both the donor and beneficiary win. Let's assume the donor's grandson is in a 10% tax bracket and she is in the 40% bracket. If she gives him the stock directly, the grandson would be able to spend $900 after paying his taxes. Or, she could sell the stock and give him the after-tax proceeds of $600. A stock gift is 50% larger than a cash gift. If grandma made that gift directly to her grandson's college, then her tax deductions would look like our previous example, and be even larger.

If you have equities or stock options and charitable intent, then talk with your financial advisor about the best way to make the largest gifts with the most tax advantages.

Donor Advised Fund

A Donor Advised Fund, or DAF, is a very popular way to gift a lot of money, receive a large immediate tax deduction, and defer the decision about which charities you want to receive the proceeds until later.

Many financial institutions and community foundations support DAFs. These organizations are registered non-profits. They will charge a fee for the management of the DAF. Money inside the DAF is invested in a wide array of investments, including equities, until the donor decides who will receive the donation.

The mechanics of a DAF are straight forward. A donor completes the paperwork and agrees to the terms. Then, the donor funds the DAF with a check or electronic money transfer. When the donor chooses a charity to sponsor, the donor recommends that charity to the sponsor (the community foundation, financial instituition, etc.) .

Importantly, the sponsor of the DAF runs the DAF. The donor cedes control to the sponsor when the DAF is funded. The donor may recommend how to invest and where to donate, but the ultimate decision rests with the DAF sponsor, not the donor. As a general rule, they do what they are told. I have not seen a situation where they refused a donor's recommendation.

If a donor agrees to these terms, the donor gets a dollar-for-dollar tax deduction in the year of donation. If the donation exceeds the charitable limits in any particular year, the tax deduction is not lost. It carries forward to the next tax year, and further years if needed. For the most up to date contribution limits and number of years you may carryforward a charitable deduction, refer to www.gotaxfreebook.com .

Family Limited Partnerships and Private Foundations

Among the most complex forms of charitable giving are family limited partnerships and private foundations. Some of the most wealthy families in America create their own businesses for the express purpose of donating the money they have accumulated to the causes they are passionate about. Although the differences between these two types of charitable planning techniques are interesting, they are largely outside our scope because the tax benefits, by and large, are similar to the next type of charitable planning technique, discussed at some length: charitable trusts.

Charitable trusts

What is a trust?

Even if you think you know the answer to this question, it is very helpful to focus on the fundamentals first. A trust is a legal agreement governing the dispensation of property. A trust has several important parts to it, each with different legal meanings:

- *Donor, settlor, grantor, trustor*: the person who initially owns the assets and sets the rules for the trust.
- *Trustee:* Different from (and commonly confused with) the donor, a trustee follows the rules of the trust to make sure the assets and income are in order and the taxes are paid. The trustee obeys the rules of the trust and works on behalf of the beneficiary.
- *Beneficiary:* The beneficiary receives some or all of the income and or assets in the trust. The beneficiary, donor, and trustee are usually not the same person.
- *The trust objective*. The trust objective determines the trust type. In other words, the objective of the trust is the donor's goal, clearly stated, regarding the dispensation of the property. Different types of trusts provide different benefits. A charitable remainder trust is a specific type of trust with an objective of providing income for the donor and future money for a charity.
- *Property:* Trust property may include securities like stocks and bonds, annuities, real estate, businesses, and other real and normal property.

How a charitable remainder trust (CRT) works

A charitable remainder trust (CRT) is a way to provide income for the beneficiary and a gift for a charity. Additionally, the donor can donate highly appreciated assets because he or she avoids paying taxes on the gains. The donor receives a tax deduction on the present value of the gift to be given to the charity.

History of the CRT

The Tax Reform Act of 1969 made the charitable remainder trust possible, and the tax benefits are governed by IRS Code 664. The money inside the CRT is tax-exempt. The income that comes from the trust is taxable to the income beneficiary. Upon the beneficiary’s death, the remainder of the CRT transfers to the charity of the donor's choice.

Rules regarding the tax deduction

The gift made to the irrevocable CRT is a tax deduction in the year of the gift. The size of the tax deduction is determined by the future residual value of the CRT. The tax deduction is not the entire value of the gift made this year. The key factors that go into this calculation include:

- Life expectancy of beneficiary
- Number of beneficiaries (the more beneficiaries, the lower the present value)
- Income rate (the higher the income from the CRT, the lower the future value)
- Residual value must always be at least 10% of the initial gift

Clearly, this calculation requires expert legal and tax advice.

The income tax deduction may not exceed 50% of the grantor's Adjusted Gross Income (AGI) for a gift in cash. Or, if the gift has capital gain appreciation, the deduction may not exceed 30% AGI. If the income tax deduction cannot be used in the first year, it may be carried forward on the donor's income tax return for up to five years.

Also note that the size of the tax deduction likely has little or no relationship to the actual amount remaining at the end of the trust's term. The charity may receive more than or less than the estimated amount at the beginning of the calculation. There is a possibility that the charity receives nothing from the CRT. Proper management by professionals is critical to avoid the possibility of the CRT value running to zero.

Avoid capital gains tax

Any appreciated asset donated to a CRT is no longer subject to capital gains tax. This is a great way for small business owners and successful investors to transfer highly appreciated assets, including the stock in their own company. A CRT is best used for highly appreciated assets, especially if the owner is worried about having to sell the assets and the associated tax ramifications.

Rules regarding the income

The donor determines the income withdrawn from the CRT, as well as the duration of that income. Generally speaking, the CRT could last for the life of the beneficiary, or the lives of multiple beneficiaries. If not set up for life, then a CRT may be set up to pay for as long as 20 years. The income can be deferred until later but once it starts, it needs to continue for the stated duration.

The income must be at least 5% of the account value per year and can be as large as 50% per year. The amount of the income depends upon whether the income stream is a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT).

CRAT: Charitable Remainder Annuity Trust. A CRAT pays a fixed dollar amount every year to the beneficiaries. Even though it is called an annuity, a CRAT is not the same as the commercial annuity we discussed earlier.

A CRAT is best for beneficiaries who want to be paid a fixed dollar amount every single year, and it is typically used for older beneficiaries. The CRAT pays a fixed income to the beneficiary regardless of the performance of the underlying investments. For example, a $1 million initial CRAT would pay at least $50,000—5% of the initial account value, as noted above— or more, depending on the donor's wishes. The income continues for the duration of the trust, which is also set by the donor.

CRUT: Charitable Remainder Unitrust. A CRUT pays a fixed percentage, but not a fixed dollar amount, every year.

A CRUT is best for beneficiaries who want inflation protection and are comfortable living with the risk that the income might decline. These are usually younger beneficiaries. The CRUT pays a percentage of the current value of the investment. For example, a $1 million dollar initial investment pays $50,000 the first year. In the second year, the income is 5% of the new account value; thus the income could either shrink or grow. If the CRT value falls to $900,000, then the income is $45,000 in year two. If it grows to $1.1 million by the second year, then the income is $55,000, or 5% of the new account value.

Recover the gift with a wealth replacement trust (WRT)

One reason folks worry about creating a CRT is that they disinherit their children or other beneficiaries. After all, everything given to the CRT is an irrevocable gift to a charity. To avoid this dilemma, the donor creates a wealth replacement trust (WRT) funded with life insurance on the donor's life. This way, when the last income check comes in upon the death of the donor, the life insurance proceeds pay a lump sum of money that replaces the charitable gift.

The donor is in control of the size of the WRT. The size of the life insurance policy death benefit could be linked to the future value of the CRT, providing a smaller benefit for the family. Or, the life insurance death benefit could be linked to the initial gift—or any other variable, for that matter. The WRT could be a way to leverage the CRT into a nice gift for charity and a much larger gift for the family.

The wealth replacement trust is held outside the donor's estate. This means that the death benefits are not subject to estate tax. Additionally, it means premiums into the WRT are considered gifts and are subject to annual gifting limits.

Refer to www.gotaxfreebook.com for this year's gifting limits. Premiums in excess of that amount count against the donor's lifetime gift tax limit. This also requires a donor to file an extra tax return, called a gift tax return, every year. It's not a complicated return, but it's an extra complexity that many people want to avoid.

An example illustrates it best. Bill and Linda donate $1 million to their CRT and simultaneously create a WRT. Their first-year income from the CRT is $50,000 per year, lasting for 20 years or the length of both of their lives (a CRUT). They use $15,000 per year to pay for a life insurance policy with a $1 million death benefit. Their tax professional estimates that the present value of the gift to their charity is $220,000, so they receive a $220,000 tax deduction in the year they make the gift. Now they have made a meaningful gift to their charity, received recognition from the charity while they are alive, provided income for themselves, and still provided a $1 million inheritance for their children.

If Bill and Linda don't need the income, they may choose to invest the entire income of their CRT in the WRT. Then they may be able to buy a significantly larger death benefit for their family, creating a larger financial legacy for their heirs.

Held outside the estate, the WRT is not subject to estate taxes upon the donor's death. Any amounts paid into the WRT above the annual gift limits count against the husband and wife lifetime gifting limit. They consult their tax planning advisors throughout the process to make sure this is the best way for them to achieve their goals.

Why not?

And why not choose a charitable remainder trust? Well, for starters, it might not work out as planned.

Income risks

The investments inside the CRT might not produce the same income that you start with if you chose a CRUT, and this could cause stress. The CRT may not generate enough income to fund the WRT life insurance premiums. These investment risks require prudence from the trustee and his or her advisors.

Asset risks

If you choose a CRAT, and enjoy a steady income, the principal might not last, and the income payments may cease before your life ends. And, of course, the charity may or may not get the entire initial planned gift. This too is an investment risk, requiring prudence from the trustee and his or her advisors.

Charitable deduction

If you just gave $1 million to a charity you would receive a $1 million deduction, compared to a significantly reduced deduction inside the CRT. Sometimes, it makes sense for the purely philanthropically inclined to put their gifts inside a box with bows and ribbons instead of wrapping it a legal trust.

Insurability

To create the wealth replacement trust, the donor must qualify for life insurance. If the donor is uninsurable, then another person could be the insured.

Children

Children may wonder why the money is going to a charity instead of directly to them, straining relationships.

Complexity

Although the plan, once understood, is fairly straightforward, it is not as easy to understand as writing a check to a charitable organization. For some folks, simplicity is in and of itself the best gift. For others, the customization that comes implicitly with a CRT and WRT is energizing and, of course, tax savings and life insurance provide additional leverage.

Afterward

For up to date information, including tax brackets and more financial planning ideas, visit www.gotaxfreebook.com

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In the winter, you can find Karl and his family skiing the Colorado slopes.

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