



Diocese of Providence

STRATEGIES FOR CLIENTS' YEAR-END CHARITABLE INTERESTS

There is no rule prohibiting the practice of charitable giving every month of the year. The fourth quarter, however, increases gift-planning activity and the need for professional advice, since a combination of holiday spirit, year-end tax concerns and solicitations from charitable organizations puts people in the giving frame of mind.

This issue provides a brief review of several techniques that can increase the philanthropic efficiency of clients who display interest and capability.

OPPORTUNITIES FOR THE SUCCESSFUL INVESTOR

One of the first questions to ask when planning a donation is: "Does your client own a marketable asset that is highly appreciated?" If so, consider recommending the desired asset rather than cash.

Consider the case of Ellen, a widow who is prepared to make a \$20,000 cash contribution to her class reunion gift fund. As Ellen owns a large portfolio of investments, mostly in long-term appreciated stock, her advisor suggests a gift of this stock over a gift of cash. Together they review her portfolio and select 200 shares of XYZ stock with a fair market value of \$100 per share purchased at a cost basis of \$20 per share. This plan

produces two tax savings instead of one: (1) Ellen avoids capital gains tax on \$16,000 of capital gain (\$20,000 – \$4,000 = \$16,000), and (2) she earns a charitable contribution deduction to use as an itemized deduction for the full fair market value of the shares (i.e., \$20,000).

Initially, Ellen declined her advisor's counsel because she felt her stock had excellent growth prospects. Her advisor pointed out, however, that Ellen could purchase additional shares of the same holding to replace the donated shares. These new shares would carry the higher purchase price as their cost basis. If, contrary to her expectations, the share value subsequently declines from its present value, a sale could then create a potentially useful capital loss.

DIVERSIFYING A SINGLE, LARGE STOCK POSITION

Henry and Marge invested in ABC stock many years ago and now have a disproportionate amount of their total investment capital in this one issue. A successful investment deserves celebration, but the downside of this situation is that the couple lacks diversification of risk. Furthermore, they invite erosion of their portfolio's value

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Securities that have declined in value can also offer a donor unique tax advantages. By selling the stock and taking a loss, the donor can offset up to \$3,000 of ordinary income. Using the sale proceeds to make a charitable gift in cash doubles the benefit.

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because of capital gains taxation on any sales made in order to diversify. With a substantial joint life expectancy, they wish to remain invested primarily in equities.

A standard charitable remainder unitrust (CRUT), initially funded with a \$300,000 block of the most appreciated shares from the couple's major holding, offers a wise solution. A CRUT will pay them jointly—and for the life of the surviving spouse—a fixed percentage (at least 5 percent) of the annually redetermined trust asset value. They choose a 5 percent payout which they realize will vary each year. The projected income (\$15,000 in the first year) however, should typically be greater than the anticipated 2 percent ABC stock dividends.

In addition, they receive a \$131,661 income tax charitable contribution deduction (the calculated present value of the remainder interest) deductible up to 30 percent of adjusted gross income. This deduction is based on their ages of 70 and 72, as well as a 5.6 charitable midterm federal rate and quarterly payments from the CRUT. Any deduction above the 30 percent limitation can be carried forward for up to five additional years. Resulting tax savings can be spent, given to heirs within annual gift tax exclusion amounts (\$12,000 per person per year) or invested.

The remainder value of the trust is irrevocably committed to one or more qualified charitable organizations; however, the donor can reserve the right in the trust agreement to change the charitable beneficiaries.

The trustee is free to sell the original trust assets in order to reinvest in other equities, with no capital gains tax payable by the trust as the CRUT itself is a tax-exempt trust. The distributions paid to the income beneficiaries are taxed to them under a four-tier system with distributions

coming first from tier one, then tier two and so forth:

- (1) Ordinary income to the extent the trust has ordinary income in the current year or the trust has undistributed ordinary income from a prior year
- (2) Capital gain first from the current year, then any undistributed gain from any prior years
- (3) Tax-exempt income
- (4) Tax-free return of trust principal

SHIFTING ASSETS FROM EQUITIES TO FIXED INCOME

Older individuals tend to become more interested in the certainty of future income and less concerned about long-term inflation reducing the real dollar value of fixed income. In this situation, a charitable remainder annuity trust with fixed payments may be an appropriate recommendation.

Your client will fund the trust initially with appreciated, low-yielding equities, which the trustee sells with no up-front capital gains tax at the trust level. As with the CRUT, the trustee can reinvest the sale proceeds for returns in line with the required annuity trust payments.

In our example above, if Henry and Marge chose a CRAT over a CRUT, they would receive a fixed amount of \$15,000 per year from the trust, regardless of the growth or decline in the value of the trust assets from year to year. Their income tax deduction for the CRAT would be \$137,745, which is slightly higher than the CRUT deduction.

OTHER POSSIBLE TECHNIQUES FOR YEAR-END GIVING

ILLIQUID REAL PROPERTY

Another attractive technique involves the funding of a flip charitable remainder

unitrust with an asset such as real estate that (1) will be difficult to sell promptly at a fair price, and (2) does not produce sufficient income to cover the minimum 5 percent stipulated annual payout.

A flip-CRUT initially operates as an “income exception” form of unitrust, paying to the income beneficiaries only the lesser of the stipulated payout percentage and actual net income earned by the trust assets (either with or without a provision for subsequent makeup payments of past deficits).

The terms of the trust shift its operation to that of a standard unitrust beginning Jan. 1 of the year after the “nonmarketable” assets have been sold, with sale proceeds invested for improved return. Accrued makeup payments, if any, for prior payment deficits are relinquished.

Thereafter, the trust must pay the full percentage of redetermined asset values to the income beneficiaries. Just like a traditional CRUT or CRAT, payments made to the income beneficiaries retain the same taxable character as their sources in the trust.

BARGAIN SALE OF ASSET WORTH MORE THAN DESIRED GIFT

At year-end your client may wish to use a real estate holding to make a charitable gift. Consider recommending a bargain sale if the total value of the real estate is greater than the intended gift.

The donor negotiates a sale of the real estate to the charity, at a price below the current fair market value of the property. The elements of a bargain sale are twofold: part gift and part sale. The tax-deductible gift is the difference between the market value of the property and the negotiated price.

For example, Jake has a building worth \$800,000 that he purchased several years ago for \$300,000. He can't afford to give the entire building to charity, but he is willing to sell it at a reduced price.

In fact, he'd like to receive his initial cost as the sale price. Jake would be eligible for a charitable deduction of \$500,000 deductible up to 30 percent of his AGI with a five-year carry-forward.

The total long-term capital gain of \$500,000 is prorated between the \$500,000 untaxed gift portion and the \$300,000 taxable sale portion. Jake would have to realize \$187,500 [$\$300,000 - (\$300,000/\$800,000 \times \$300,000)$] of capital gain income, which is much less than recognizing \$500,000 of capital gain income had he sold the entire property instead.

A contribution of mortgaged property, for example, also can be treated as a bargain sale. The amount of the debt is considered the amount of “payment” your client receives from the charity. This situation may create taxable gain because he/she receives value (i.e., release from the mortgage) in exchange for the gift.

To be acceptable to a charitable organization, the margin between the fair market value and bargain sale price needs to be sufficient to ensure a reasonable realization for the philanthropic purpose and to protect your client from any short-term market decline while the transactions take place.

THE 50 PERCENT ELECTION OPTION

As we've highlighted earlier, charitable gifts of long-term capital gain property are deductible as itemized income tax deductions up to a maximum of only 30 percent of the donor's adjusted gross income in the year of the gift. Compare this with gifts of cash, which have a maximum deduction of up to 50 percent of the donor's AGI. Under both options, any carry-forward can be taken within five additional years.

A step-down election, however, is available if the donor claims as a

Remember, a well-rounded financial plan may be enhanced through charitable gifts.

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Most clients, if presented with all their available options, will choose to benefit a community project or create a sense of significance through a charitable gift.

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deductible value only the cost basis in the gift property. The deduction then qualifies for use up to the annual limit of 50 percent of AGI, as for cash gifts, with up to five carry-forward years if needed.

For donors using an asset that is only slightly appreciated, it may be advantageous for them to limit the claimed deduction to the asset's cost basis, thus accelerating a larger tax savings. The election must apply, however, to all contributions of capital gain property made to public charities during the year. The technique can make it possible to use the entire deduction for a very large philanthropic gift when compared with the donor's income level.

THE ALTERNATE YEAR STRATEGY

Charitable individuals who no longer have itemized deductions such as property taxes and mortgage interest may find that total deductions consisting primarily of charitable gifts are about the same as the available standard deduction they customarily use.

In that situation, they may consider a significant year-end gift as a possible reason

to itemize for the year in question. Such donors may also consider a regular strategy of taking a different approach in alternate years. In every other year they make no charitable gifts of significance and take the standard deduction. They double gift amounts, however, in the alternate years when they itemize on their tax returns.

COMPLETED GIFTS FOR TAX PURPOSES

Type of Gift	Gift Effective Date
Gift by check	The date the check is mailed or delivered
Credit card	The date the gift is charged to the credit card
Securities delivered electronically	The date of posting to the charitable organization's brokerage account
Securities sent through the mail	The date of mailing
Securities hand delivered	The date of delivery
Real estate	The date the executed deed is delivered to the charitable organization

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Our site offers a complete array of information and tools for your use as you advise your clients on their gifts to Catholic Foundation of Rhode Island—Bequest Language, Gift Calculator, and a Professional Advisors Reading Room that covers a full spectrum of planned giving and estate planning articles written by national experts.



www.providencediocese.org/foundation.htm