

Charitable Planning

PERSONALIVES



Diocese of Providence

GIFT PLANNING BASICS— MATCHING METHODS TO MOTIVES

Clients have a variety of reasons for considering a significant charitable gift. Fortunately our tax structure and its incentives for philanthropy have developed an equally varied array of giving methods. Following is an overview of some of the most common and popular gift vehicles.

Most gifts fall into one of three groups:

- 1) a single outright lifetime transfer or series of annual gifts;
- 2) revocable arrangements for a future gift;
- 3) irrevocable provisions for a deferred gift.

In order to choose the appropriate giving method, a good planner needs to understand the donor's motives. Factors influencing your recommendation include the donor's financial and tax situation, and personal objectives. In some situations, the guidelines and needs defined by the charitable organization will affect the decision.

OUTRIGHT LIFETIME GIFTS

The most common form of charitable giving is writing a check, but that also can be the least cost-effective. The following alternatives to cash gifts produce current or near-term philanthropic support.

Long-term appreciated and readily marketable property. Other than cash, this

is the simplest and most frequently used alternative. Stock is the most common type of asset used, but real property is also a viable option.

The result is a double tax savings: One from the itemized deduction, the other by completely avoiding capital gains taxes. Fifteen percent of total appreciation can be lost to capital gains taxes on a sale, more if subject to state taxation as well as federal. Reduction or elimination of eventual transfer taxes results in a third savings.

A donor wishing to maintain a stock position may hesitate to make a gift of shares, preferring instead to use cash. The shares, however, should still be used for the gift because cash can be used to buy the same number of shares at a higher basis, reducing capital gains tax on a subsequent sale or producing a useful capital loss.

Nonmarketable closely held stock.

A minority block of nonmarketable closely held stock can make an economical gift. The stock can be redeemed by the corporation at its discounted value, although the redemption cannot be a condition of the gift. If redeemed and not reissued, all retained shares increase in value. Also, an appraisal will be necessary if the donor wants to deduct more than \$10,000.

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Mutual funds have grown in popularity among investors. These shares offer the same general advantages as gifts of individual stocks. Valuation is the published redemption (i.e., bid) price on the date transferred to the charitable organization's account.

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Life insurance policies with cash surrender value. Donors who no longer need death benefits can discover hidden assets in their paid-up life insurance policies. This transaction avoids the need for any subsequent premium payments and removes death benefits from the estate. To accomplish this gift, contact the insurance company for a change of ownership form along with a change of beneficiary form. Complete both forms and return to the insurance company. The date of the gift is ordinarily the date the forms are signed by the donor. The charitable income tax deduction is limited, however, to the lower of cost basis (which is usually the premiums paid) or fair market value which, for policies with ongoing premiums still required, is typically the interpolated terminal reserve value.

Charitable lead trusts. This is an underused option for near-term support, such as for a capital campaign. For a term of years after funding the split-interest trust, payment of the income interest is distributed to one or more designated charitable organizations. At termination of the trust the remainder passes to named individual beneficiaries, at a reduced taxable value.

For example, a 65-year-old donor establishes a charitable lead annuity trust with \$1 million in cash. The payment to the charitable organization is 7 percent or \$70,000 each year for 15 years. At the end of the term, the trust's assets are distributed to his children. The donor receives a gift tax deduction of \$730,690 leaving this gift subject to gift tax on the balance or \$269,310, enabling the donor to transfer the trust assets to heirs with reduced transfer taxes.

REVOCABLE ARRANGEMENTS FOR FUTURE GIFTS

Estate distributions. These are the most frequently used revocable arrangements,

which can be implemented by a bequest in the donor's will. They can also come in the form of comparable provisions in a living trust that serves as a dispositive instrument at the grantor's death. In fact, almost 80 percent of deferred gifts come to charitable organizations in the form of bequests. Since wills and living trusts can be revised, there is no income tax charitable deduction for establishing the plan. If tax laws are left unchanged, the donor's estate receives a charitable estate tax deduction for the amount left to charitable organizations. Further, there is no limit on the amount in an estate that can be bequeathed.

Life insurance. Aside from the outright gift of a policy with cash value noted earlier, life insurance is a versatile tool for both revocable and irrevocable gift plans.

Revocable gift advantages include:

- Death benefits for a charitable organization reduce a taxable estate and pass contractually outside of probate, in confidence, and are less subject to contest by a disgruntled heir than a bequest through a will.
- The gift involves no administrative expense or settlement costs.

The simplest way to use life insurance is to name a qualified charitable organization as the beneficiary (not policy owner) of a new or existing policy. The insured policy owner retains the power to change the beneficiary designation, making it a revocable plan with no completed gift and no current income tax deduction. If the organization is made policy owner, annual unrestricted cash gifts to cover premium costs are tax-deductible.

Qualified pension plan assets. Many people remain unaware of how income tax liability erodes the value of their retirement plans. Funded with pretax income, and appreciated without being taxed, their total value remains subject to income tax if taken by the participant, transferred to heirs or left in the estate to be taxed as

income in respect of a decedent (IRD). With an estate subject to estate tax, what is left is then taxed again, consuming as much as 65 percent of the account, notwithstanding state income and death taxes.

These assets can be the most costly gift to heirs. Conversely, they make an efficient revocable charitable gift, easily arranged by a plan's beneficiary designation and not taxable as IRD to the charitable organization. In order to arrange this type of gift, simply obtain a change of beneficiary form from the retirement plan provider. If the donor is married, the spouse will need to sign a waiver to name someone other than the spouse as beneficiary of a retirement plan. This waiver, however, is not required if the asset is an IRA.

IRREVOCABLE PROVISIONS FOR FUTURE GIFTS

Split-interest charitable remainder trusts. These types of arrangements provide the greatest tax advantages, including an immediate tax deduction, avoidance of up-front capital gains tax, increased lifetime income and reduced estate taxation.

There are two broad types of remainder trusts. Those with fixed dollar payments to income recipients are *charitable remainder annuity trusts* or CRATs, typically preferred by older grantors. Those with a variable income stream, depending on growth or decline in the value of the trust's assets, are *charitable remainder unitrusts* or CRUTs. Grantors with a longer life expectancy and concerns about inflation are likely to prefer a unitrust with its potential for growth in income when investments include equities. In addition, there are four variations of unitrusts to offer donors still more flexibility: a standard unitrust, net income with makeup provisions unitrust (NIMCRUT), net income with no makeup provisions unitrust (NICRUT) and a flip unitrust.

For example, a 75-year-old donor uses \$100,000 in securities to establish a standard charitable remainder unitrust paying 6 percent per year. The donor's charitable income tax deduction is \$55,807 based on a 5.2 percent charitable midterm federal rate. In the first year, he will receive \$6,000. Each year after that, the payment will be determined by the value of the assets in the trust and hence the amount of the payment will vary each year. The payments are taxable to him under the four-tiered system for charitable remainder trusts.

Charitable gift annuity contracts (CGAs). CGAs are the oldest form of income-producing charitable gifts, dating back to the mid-1800s, but are not available in all states or offered by all organizations. Charitable organizations that enter into such contracts are the issuer and payor of income for one or two annuitants.

Some donors will prefer a gift annuity contract to a charitable remainder annuity trust, for any of several reasons. For older annuitants, the annuity rate can be higher than what would be available from a CRAT. Payments received are partially nontaxable for a number of years, considered as return of investment in the contract.

The transaction is in part a charitable gift and in part the purchase of the income interest. When a donor transfers marketable, long-term capital gain property instead of cash in return for the annuity interest, the amount of appreciation in the property is prorated between the gift portion and the purchase portion. There are two advantages related to capital gain. One, the amount allocated to the gift portion completely avoids capital gains tax. Two, the portion to be recognized can be spread over the projected term of the contract when the donor is the income beneficiary, and any tax deferred is money saved. Note, however, that the last advantage is offset to

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Follow-Up on Spousal Elective Rights for Charitable Remainder Trusts

The IRS issued Notice 2006-15 which extends the safe harbor date of Rev. Proc. 2005-24 addressing a surviving spouse's right of election to receive an elective share of the deceased spouse's estate. Many commentators have voiced their concern over the undue hardship this Revenue Procedure places on taxpayers and advisors. As a result, the IRS is extending the June 28, 2005, grandfather date until further guidance is published. For now, the IRS will disregard the existence of the spousal right of election without a waiver, but only if the surviving spouse does not exercise the right of election.

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some degree because the prorated lower-taxed capital gain portion of annuity payments squeezes out an equal amount of untaxed return of investment.

Other benefits of a CGA:

- The arrangement requires a simple contract, with no need for a trust agreement.
- The obligation to pay the annuity is a claim on all assets of the issuer.
- Start of payments can be deferred, which increases the initial itemized deduction and the annuity rate.

For example, our same 75-year-old donor from an earlier example makes a gift of \$100,000 worth of highly appreciated securities with an original cost basis of \$25,000. The donor receives a \$44,988 charitable income tax deduction based on a 5.2 percent charitable midterm federal rate. The donor can deduct this amount up to 30 percent of adjusted gross income with a five-year carryforward. The donor receives fixed payments of 7.1 percent, or \$7,100, for life. Each payment is taxed as follows:

\$1,109	income tax-free
\$3,328	taxed as long-term capital gain
<u>\$2,663</u>	taxed as ordinary income
\$7,100	total payment

After 12.4 years when the donor reaches his or her life expectancy, the entire \$7,100 will be taxed as ordinary income.

SPECIAL SITUATIONS

Tangible Personal Property

To be tax-deductible for its appraised value, a lifetime gift of tangible personal property must be long-term capital gain property, usable and used by the organization in a way that is related to its purpose. Otherwise the gift is deductible only for the lower of its fair market value or cost basis. The related use requirement does not apply to charitable bequests. Therefore, for gifts of tangible personal property unrelated to the organization's mission, a charitable bequest may be preferable over a lifetime gift of the asset.

Potential benefits of lifetime gifts include the elimination of special insurance coverage for items in the home and a reduction of a taxable estate. If the items would otherwise be sold, donating them avoids the high commissions charged by auction houses or low prices paid by dealers compared to fair market value.

Current Maximum Suggested Annuity Rates

Age	Single Annuitant	Two Annuitants, Same Age
60	5.7%	5.4%
70	6.5%	5.9%
80	8.0%	6.9%
90	11.3%	9.3%

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