AN OVERVIEW OF CHARITABLE GIVING OPTIONS

A PRESENTATION MADE TO MEMBERS OF THE SOUTHWEST WASHINGTON ESTATE PLANNING COUNCIL

October 14, 2014

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Introduction

Charitable giving can take many forms. The focus of this presentation is relatively large gifts made by individuals to certain types of charitable organizations, often in ways that result in tax deductions. The presentation also devotes attention to the roles of donors, their advisors, and charities in the process of arranging charitable gifts.

Definitions

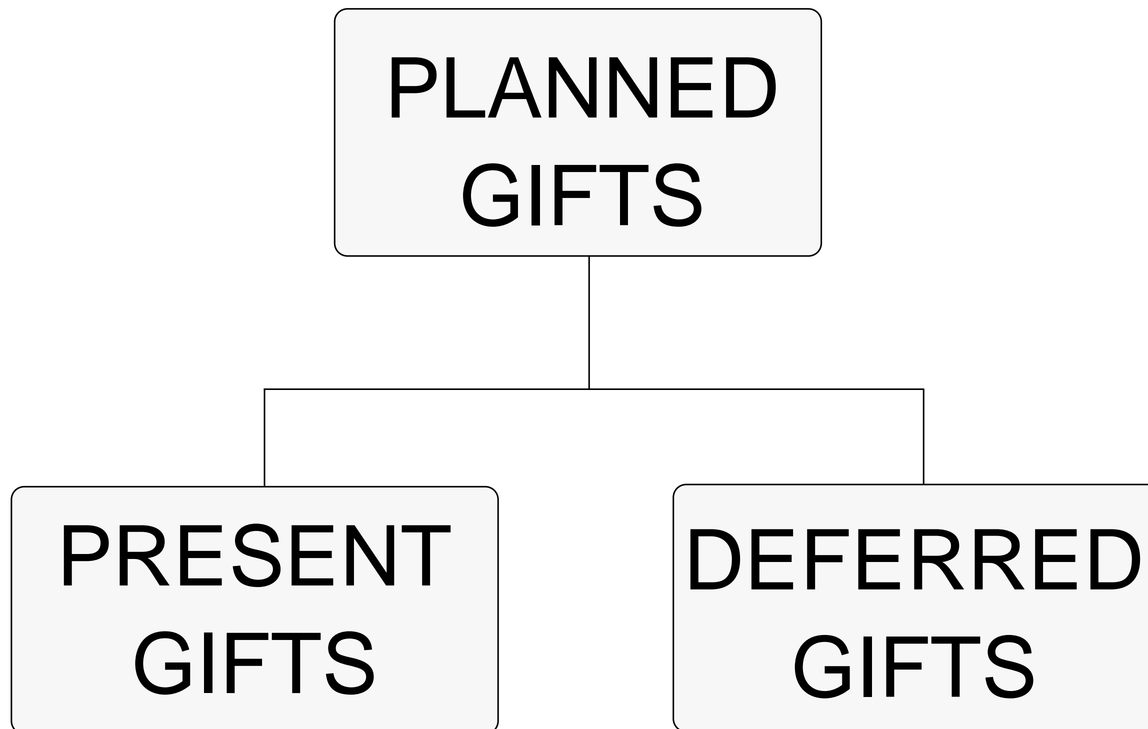
Planned giving, also known as ***gift planning***, is the designing of charitable gifts so that donors realize philanthropic objectives while maximizing tax and other financial benefits.

A ***planned gift*** is any sizable charitable contribution made with forethought about the benefit to the charity and the financial implications to the donor and the donor's family.

From a donor's point of view, planned giving is merely part of the overall process of ***estate planning***, which can be defined as: "caring for yourself and your assets while you are living, and providing for the transfer of assets to other persons and entities, both during your lifetime and afterwards."

Characteristics of Planned Gifts

- They are generally made from assets, rather than from income.
- They typically require the involvement of persons besides the donors themselves, e.g., lawyers, accountants, stockbrokers, insurance agents, real estate agents, financial advisors, trust officers, appraisers, and institutional gift planners.
- They usually occur in response to developments in the lives of donors, meaning that, in any given instance, the charity's notion of optimal timing is often a secondary consideration from the point of view of the donor.
- They result mostly from deep commitments of donors to the missions of particular organizations; tax incentives and various financial benefits influence the nature, size, and timing of a gift but not the basic decision to give, which is ultimately a function of psychological factors and practical considerations.
- They are ideally suited for bolstering endowments (or funds that serve the function of an endowment).



Planned gifts include both:

PRESENT GIFTS that the charity can use now (either for operations or for endowment), and

DEFERRED GIFTS that are committed now but not available to the charity until sometime in the future (either for operations or for endowment).

Types of Organizations to Which Charitable Gifts May Be Directed

Charitable gifts to any of the following entities qualify for a charitable deduction, though the amount of the total deduction and the amount that can be deducted in any year depend on the type of charity and the kind of property contributed.

1. A Public Charity That Carries on Any of a Variety of Activities

Examples: a religious organization, a college, a nonprofit hospital, a United Way, The Nature Conservancy, etc. The gift to the public charity could be (a) entirely without restriction, (b) for a designated purpose, or (c) to establish an endowed fund (either for the general use of the charity or for a designated purpose).

2. A Community Foundation

For tax purposes, a community foundation is a public charity. However, its role is to make grants to other public charities. Some also grant scholarships to individuals in ways that fulfill applicable federal tax requirements.

Many community foundations, such as the Community Foundation for Southwest Washington, serve a defined geographic area and make grants either primarily or exclusively in that area. Others concentrate their grant making on, or limit it to, public charities with certain affinities, sometimes in a geographic context. Examples include local Jewish federations, the Presbyterian Foundation, and Pride Foundation. Still others operate nationwide and make grants to organizations that meet federal tax qualifications. An example would be the Fidelity® Charitable Gift Fund.

Generally, a donor may establish within a community foundation any of the following component funds:

- Unrestricted or Discretionary Fund
- Area of Interest Fund
- Designated Fund
- Donor Advised Fund

3. A Supporting Organization

For tax purposes, a supporting organization is treated as a public charity. It is established, either by a donor or by a public charity, to provide financial support to one or more public charities. A donor might create a supporting organization to provide funds for the work of a particular public charity, such as a university, or several public charities (either directly or through a community foundation).

4. A Private Grant-making Foundation

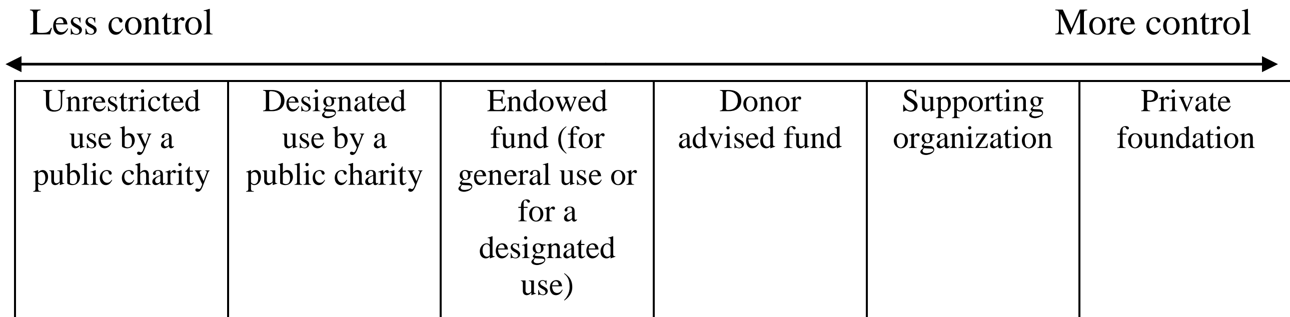
For tax purposes, a private grant-making foundation is not treated as favorably as a public charity. Nevertheless, it offers a donor the greatest degree of control over the investment of contributions and grant making activity. Private foundations could have billions of dollars of assets or only a few hundred thousand dollars of assets.

5. A Private Operating Foundation

Like a private grant-making foundation, a private operating foundation is usually established by a single donor or by the members of one family, and it has an independent board which invests foundation assets. Unlike a private-grant-making foundation, however, it actually conducts charitable work. For example, it might operate a museum or a botanical garden. For tax purposes, contributions to it are treated the same as contributions to a public charity.

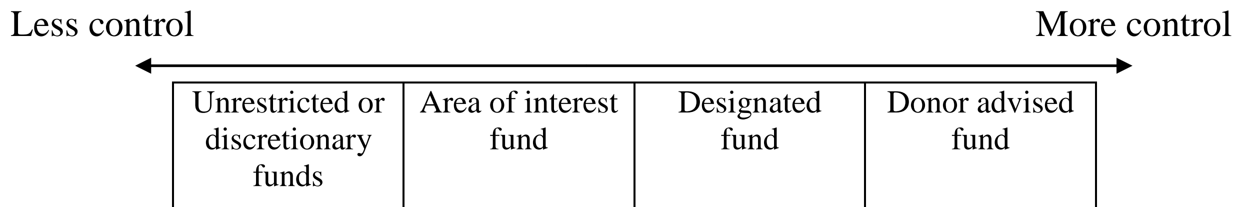
<u>Degrees of Control Retained by the Donor</u>

Each of the following diagrams shows on a continuum the degree of control exercised by the donor, whether in the case of certain charitable entities:


Less control ⟷ More control

Unrestricted use by a public charity	Designated use by a public charity	Endowed fund (for general use or for a designated use)	Donor advised fund	Supporting organization	Private foundation

or in the case of component funds of a community foundation: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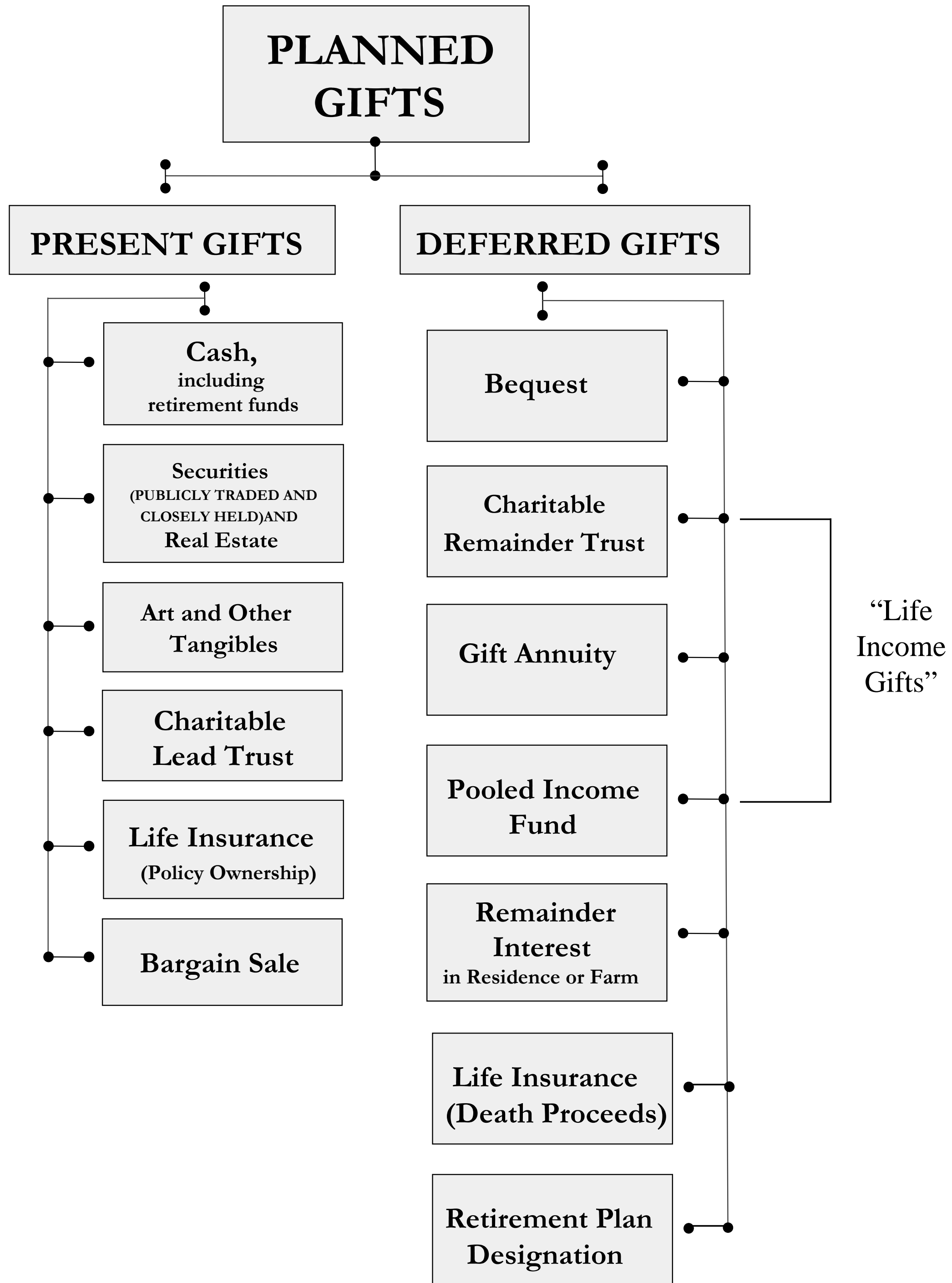
Unrestricted or discretionary funds	Area of interest fund	Designated fund	Donor advised fund

Types of Planned Gifts



Particular Gifts for Particular Situations

Situation One

Ms. A wishes to contribute $25,000 to a favorite charity. In so doing, she could draw upon either $25,000 cash or publicly-traded stock acquired several years ago for $10,000 and now worth $25,000.

Appropriate Gift Arrangement: Regardless of which asset Ms. A chooses to donate, she will receive an income tax charitable deduction of $25,000. Nevertheless, if she transfers the stock directly to the charity, she also avoids paying tax on any of the $15,000 in long-term capital gain.

Now, consider these questions:

1. What happens if she sells the stock and contributes the cash proceeds?
2. What if the stock has been acquired within the last year?
3. What if the stock has a cost basis of $30,000, rather than $10,000?
4. Can Ms. A use the $25,000 cash to reestablish her position in the stock?

Brief Overview of Outright Transfers of Assets

Often, the most tax-efficient asset to give is something other than cash. As noted above, long-term appreciated capital assets are typically the best, with one exception: only rarely will tangible personal property – regardless of how long it has been owned by a donor and regardless of how much it may have increased in value – be appropriate to give to most types of charitable organizations during life. Accordingly, the donor may well be better off selling it and giving the proceeds (or simply retaining the property and leaving it to charity in his or her will).

The actual process for transferring an asset depends on the asset. For stock, electronic transfers are the norm, although shares held in certificate form require a different process. With real estate, a deed is necessary. Transferring other types of assets may entail other considerations.

Likely Donors

- All donors, especially those with appreciated assets, who can afford to give some of those assets without retaining income.
- Donors who would like to establish an endowed fund during their lifetimes.
- Donors who are interested in helping to meet current needs.

Situation Two

Mr. B, a widower, rolled his late wife's IRA into his own. He would like to leave a charity approximately $500,000, with the balance of his estate going to his two children. His total estate

is approximately $4,000,000 and consists of the $500,000 in his IRA, appreciated securities worth $2,000,000, cash and equivalents of $500,000, and a home and personal property worth $1,000,000. What asset should be used for his charitable gift?

Appropriate Gift Arrangement: – Mr. B could give $500,000 from his general estate assets to the charity and the IRA to his children. If he did so, these would be the tax consequences:

State estate tax savings (16% x $500,000)	$ 80,000[1]
Net cost of gift ($500,000 - $80,000)	**$420,000**

If instead he gave the IRA to the charity and other assets to his children, the tax consequences would be better:

State estate tax savings	$80,000	
Estimated federal income tax savings		
$500,000 x 28%	140,000	(assuming a 28% tax rate
Total tax savings	220,000	for the children)
Net cost of gift ($500,000 - $220,000)	**$280,000**	

(1) Assuming Mr. B died in 2014, his estate is below the $5.34 million exemption level for federal estate tax but exceeds Washington State's $2,012,000 exemption amount.

Note: The income tax savings are effectively realized by Mr. B's heirs, rather than by him or by his estate.

Brief Overview of Retirement Plan Beneficiary Designations

There will always be income tax savings vis-à-vis simply making a bequest of general estate assets to a charitable organization and naming one or more tax paying individuals as beneficiary(ies) of an IRA or a qualified retirement plan. To the extent state or federal estate tax applies, the savings will only be greater.

Such gifts are very easy to arrange. All the donor needs to do is complete a beneficiary designation form and submit it to the financial services company that maintains the donor's IRA or qualified retirement plan. At any point thereafter, so long as the donor has the necessary legal capacity, the designation can be revised or revoked.

Likely Donors

- Almost everyone, but especially donors in their 50s and up who are beginning to formulate estate plans and think about the distribution of their estates.

- Donors who want to retain control of all their assets during their lifetime.

- Donors with relatively few heirs.

- Donors interested in assuring continued support through an endowment. (Some individuals endow their annual gifts to assure continuance of support.)

- Donors who have substantial amounts in their IRA or qualified retirement plan, are concerned about taxes imposed on those assets, and can provide adequately for heirs without using all of these assets.

Note: Drawing upon assets in an IRA or a qualified retirement plan to make a charitable gift during life is not an especially attractive option, especially if the donor is under age 59-1/2. The best approach is to withdraw cash, contribute long-term capital gain assets to charity, and then use the cash to invest in something that replaces the contributed assets. That being said, at least for 2006 through 2013, donors over age 70-1/2 had a somewhat limited ability to make direct transfers to charity from their traditional IRAs only (as well as from Roth IRAs although not from other types of IRAs or from any type of qualified retirement plan). Such a transfer did not result in an income tax charitable deduction, but neither did it increase the donor's adjusted gross income. Charities nationwide continue to urge Congress not only to renew the availability of this technique (and make the extension permanent), but also to (1) remove some of the limitations, such as the $100,000 annual ceiling, (2) enable donors to use distributions from IRAs to establish various life income arrangements, and (3) allow donors as young as 59-1/2 to pursue these options. Different bills pending in both house of Congress would accomplish at least some of these objectives.

Situation Three

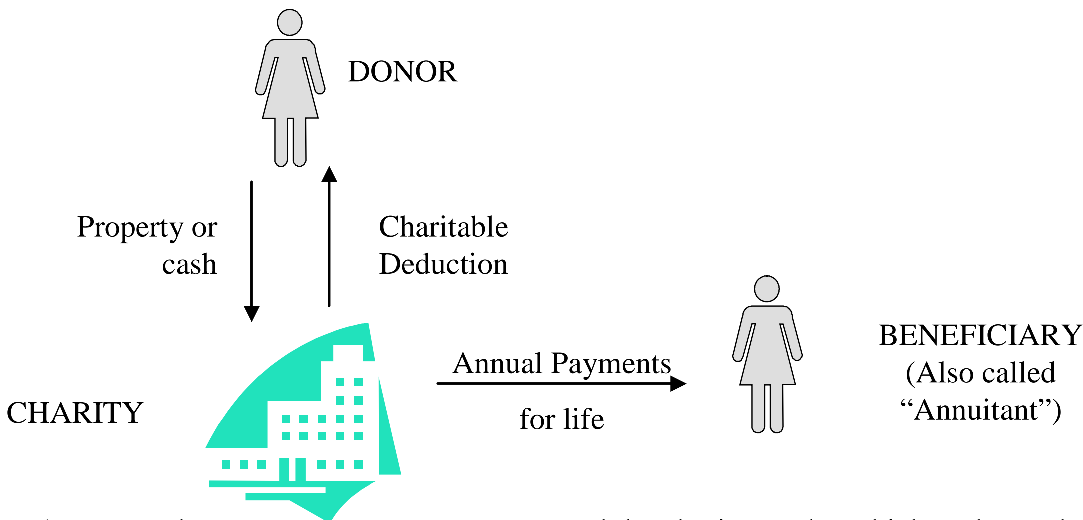
Ms. C, age 79, has a $50,000 certificate of deposit that has just come due. She hesitates to roll it over into a new certificate, however, because the interest rate paid by her bank is only about 2 percent. She is also in a position to consider making a charitable gift of some of her cash to the college from which she graduated, so long as she does not diminish her cash flow.

Appropriate Gift Arrangement: A charitable gift annuity. On October 14, 2014, Ms. C contributes $50,000 cash to her alma mater, which contractually agrees to pay her $3,300 each full year for the rest of her life. She receives an income tax deduction of $24,266 in the year she makes her gift, and, as noted below, the payments she receives are taxed favorably for many years to come.

Year	Payments	Total Amount	Ordinary Income	Tax-Free Amount
2014	1 partial	$708.42	$150.19	$558.23
2015-2023	4 full	3,300.00	699.60	2,600.40
2024	4 full	3,330.00	1,527.83	1,772.17
2025+	4 full	3,330.00	3,300.00	0.00

At the end of her life, the portion of her contribution that remains is used to establish an endowed scholarship fund.

Brief Overview of Charitable Gift Annuities



- A contract between one or more persons and the charity, under which cash or other valuable property is contributed by the donor(s) in exchange for a specified amount paid at stated intervals (no less often than annually) for the life of one or two persons.

- Charitable deductions allowed for difference between amount contributed and present value of annuity payments.

- Immediate annuity: payments begin immediately following contribution.

- Deferred annuity: payments begin at a designated future time, which must be at least one year after the contribution date.

- Annuity rate based on age(s) of beneficiary(ies) but usually reduced – when real estate or some other illiquid asset is contributed – to help offset the risks born by the charity. (Such risks can also be offset to some extent by deferring the start of payments.)

Note: Gift annuities are fairly extensively regulated by the Office of the Insurance Commissioner. The same holds true in certain other states, e.g., California, Florida, New York, and Tennessee. Also, almost all charities offer the same annuity rates: those suggested from time to time by the American Council on Gift Annuities. This means a donor interested in establishing a gift annuity can base his or her decision on which charity he or she wants to support, rather than on which charity offers the better "deal." In any event, the annuity a charity will pay a person of a given age in exchange for a particular amount of money will always be less than the annuity an insurance company will pay the same person. For this reason, a charity will sometimes "reinsure" a gift annuity by using a portion of the contribution to purchase a commercial annuity that pays the same amount the charity has contractually agreed to pay the annuitant(s). The balance of the contribution then becomes available to the charity for it to use, subject to any requirements imposed by the donor.

Likely Donors

- Oldest group of donors – age 65 and up.
- Donors who want fixed, reliable payments.
- High tax-bracket donors who would like part of cash flow to be tax free.
- Donors interested in assisting an elderly parent.
- Deferred annuity: Mid-life professionals and executives who are interested in a supplemental retirement plan.

Situation Four

Mr. and Mrs. D, both of whom are 68 years old, own a piece of undeveloped land. They acquired it some years ago for $50,000, and it is now worth $250,000. They would like to sell the land and use the proceeds from the sale to produce income during their retirement years. Nevertheless, they are reluctant to do so because they know that the proceeds will be reduced by $30,000 (the capital gains tax owed on the $200,000 worth of appreciation). In reviewing their overall estate plan, they realize that they can afford eventually to leave something for the benefit of various charities, provided they retain enough to support themselves during their lifetimes.

Appropriate Gift Arrangement: A charitable remainder trust, specifically a charitable remainder unitrust with a "flip" provision. Mr. and Mrs. D deed the property to such a trust. The trustee sells the land and retains all of the proceeds within the trust, due to the fact that the trust is a tax-exempt entity. Each year beginning in the year after the sale takes place, an amount equal to 6 percent of the value of the trust's assets, as determined at the start of the year. If that value increases from one year to the next, then their payments will increase as well. In the year the trust is established, they receive a $79,107 income tax deduction. The payments made by the trust in quarterly installments each year will likely be taxed to them partly as ordinary and partly as capital gain, depending on the nature, extent, and timing of the trust's income. Once both Mr. and Mrs. D have died, the trust's remaining assets will be used by the charity or charities Mr. and Mrs. D have designated as beneficiaries.

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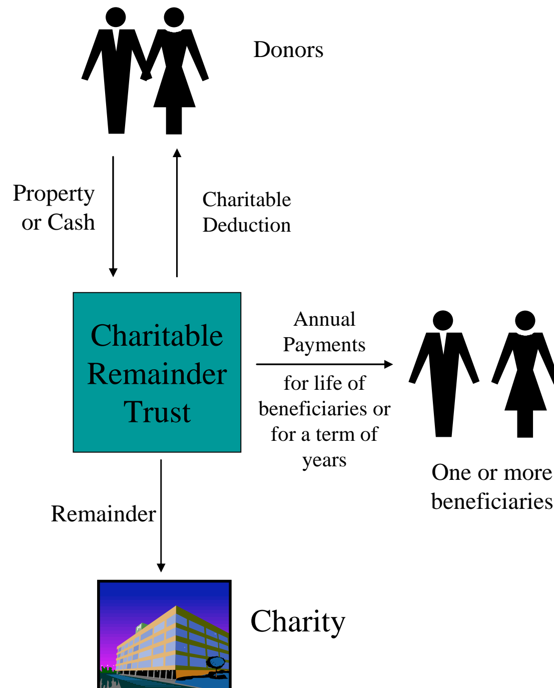
Brief Overview of Charitable Remainder Trusts



A charitable remainder trust is an irrevocable trust, established by the donor(s) either during life or at death, which pays to one or more beneficiaries, at least one of which is not a charity, for the life of the beneficiaries, or for a term not exceeding 20 years, a specified amount until the termination of the trust, at which point the trust remainder is paid to, or for the use of, one or more charitable organizations. The specified amount paid to beneficiaries must be either (1) a fixed dollar amount, which is not less than 5% or more than 50% of the initial fair market value of the property transferred to the trust, or (2) a fixed percentage, which is not less than 5% or more than 50% of the net fair market value of trust assets re-valued annually. Option (1) is a charitable remainder annuity trust, or "CRAT," and Option (2) is a charitable remainder unitrust, or "CRUT."

Likely Donors

A. Charitable Remainder Annuity Trust

- Donors age 60 and up.
- Donors with appreciated securities.
- Donors with tax-exempt securities.
- Older donors who want the security of fixed, predictable income.
- Donors interested in providing a college education to a child or grandchild, or in helping to support an aged parent.

B. Charitable Remainder Unitrust

- Donors age 50 and up.
- Donors with appreciated securities or real estate.
- Donors interested in potential income growth to offset inflation.
- Mid-life professionals who want to accumulate for retirement.
- Owners of closely-held companies.

Situation Five

Mr. E, a widower age 75, has substantial wealth, a portion of which he would ultimately like to share with his two children, who are now in their 40s. Nevertheless, he is mindful of the fact that beyond a point, any transfers he makes to his children or other individuals will be subject to gift or estate tax. Even though he has earmarked some of his wealth for eventual distribution to charity as a way to lower the value of his taxable estate, he is also eager to support certain organizations on a current basis.

Appropriate Gift Arrangement: A charitable lead trust, specifically a "nongrantor" charitable lead annuity trust. Mr. E transfers publicly traded stock worth $2 million to a trust with a duration of 12 years. At the end of each year, the trust will pay a favorite charity $140,000 (i.e., 7 percent of the initial value of the stock used to establish the trust). When the trust ends, its assets (which may be worth more – or less – than $2 million by that time) will be divided equally among his children. At the time he creates the trust, he receives a gift tax charitable deduction of $1,462,520, meaning that the likely sizable future distribution of trust assets made to his children when the trust terminates is treated as a current transfer of a future interest with a present value of only $537,480. (Whether he will actually owe any gift tax in connection with this arrangement will depend on several factors.)

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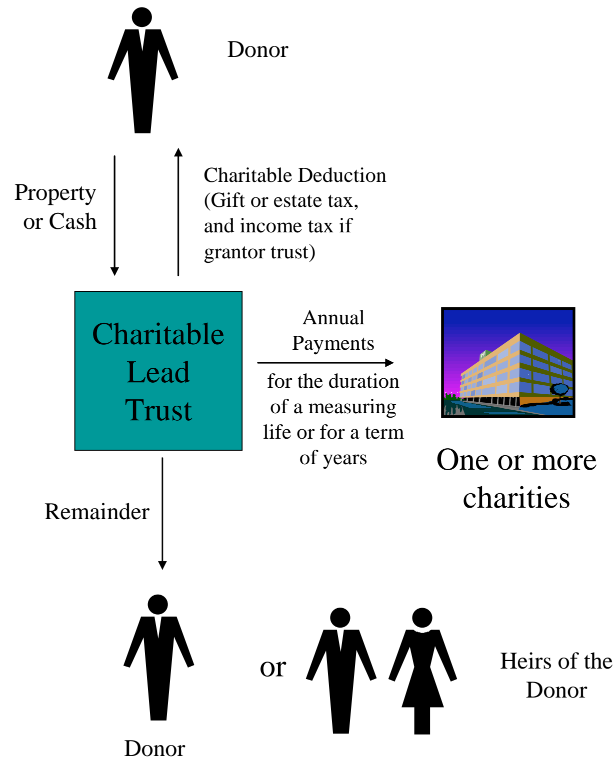
Brief Overview of Charitable Lead Trusts



A charitable lead trust is the reverse of a charitable remainder trust. Instead of paying income to one or more individuals and then distributing the remainder to one or more charities, it pays income to one or more charities, and then distributes the remainder to one or more individuals, usually heirs of the donor. If the distribution is made to the donor (or if the trust has certain other characteristics), the trust is referred to as a "grantor" charitable lead trust and establishing it results in an income tax deduction for the donor, although he or she – rather than the trust – is also taxed on the trust's income. Grantor lead trusts are far less common than non-grantor trusts, which are taxable entities.

A charitable lead trust can be established during the lifetime of the donor or at the donor's death through a will. The term of the trust can either be a fixed number of years or the life or lives of a permissible person or persons living when the trust is created. Unlike a charitable remainder trust, the fixed term of a lead trust can exceed 20 years. Also, whereas a charitable remainder trust has a 5% minimum payout rate and a 50% maximum payout rate, a lead trust has no minimum or maximum. The amount paid can either be an annuity (i.e., a fixed amount) or a unitrust amount (i.e., a fixed percentage of the value of the trust's assets as that value changes from year to year.)

Likely Donors

- Very wealthy donors who want to pass property to children or grandchildren at reduced transfer tax costs.

- Donors who want to defer distribution to heirs until they are more mature.
- Donors who would benefit from a large deduction this year but eventually want to recover the asset (grantor lead trust).

Note: Charitable lead annuity trusts (although not charitable lead unitrusts) are extremely attractive currently, due to the very low federal discount rates available for selection in making the tax calculations. In fact, it is not all that difficult to structure a charitable lead annuity trust (CLAT) so that the present value of the charitable interest equals 100 percent of the value of the assets used to fund the trust; the trust must simply last for a sufficiently long period of time and/or have a sufficiently high annuity rate.

A grantor retained annuity trust (GRAT) is appealing now for the same reason that a charitable lead annuity trust is appealing: it is possible to set the trust term and payment amount so that there is no taxable gift. Then, whatever remains in the GRAT when it terminates will pass to heirs of the grantor free of gift tax. If the grantor dies prior to the end of the trust term, all of the remaining trust assets are included in the grantor's estate. This also would have been the case, however, if the trust had not been established. If the GRAT can generate a return in excess of the discount rate used in making the tax calculations, the donor can pass the increase in value on to heirs without incurring any gift tax.

The gift tax deduction available for establishing a GRAT must be calculated using the IRC Section 7520 rate for the month in which the trust is established. The grantor does not have the two-month "look-back" option that is available when computing the charitable deduction for a CLAT. Indeed, a GRAT is not a charitable vehicle, but it can be a way simultaneously to pass property to one or more heirs and support one or more charities if the grantor uses a portion of the trust payments to make charitable gifts, as shown in the following example.

In September of 2014, Ms. E transfers stock valued at $1,000,000 to a GRAT that will pay her $214,000 per year for five years and then distribute the trust remainder to her children. Each year while the trust is in existence, she makes charitable gifts totaling $150,000 to various charities.

Amount transferred to the GRAT	*$1,000,000*
Annual payment to Ms. E	*214,000**
Total payments to Ms. E over five years	*1,070,000*
Taxable gift to children	*-0-*
Presumed value of trust assets at the end of five years (If the stock is transferred when the market is down, there is potential for a good total return.)	*250,000*
Amount passed to children gift-tax-free	*250,000*
Total charitable gifts (5 years x $150,000 per year)	*750,000*
Tax savings from charitable gifts (35% tax rate)	*262,500*
Payments to Ms. E less charitable contributions, less estimated tax on her payments	*~ 210,000*

Summary:

Total benefit to Ms. E ($262,500 + ~210,000)	*~$472,500*
Total wealth passed to children	*250,000*
Total charitable gifts	*750,000*
Total benefits to all parties combined	*~$1,472,500*

**This is the annual payment – rounded up to the next thousand dollars and made at the end of each year – that reduces Ms. E's taxable gift to $0. Thus, all of her gift and estate tax exemptions are preserved for other taxable transfers.*

Because the payments made to charity each year by a grantor CLAT are "for the use of" charity, the income tax charitable deduction the donor receives upon creating the trust can be used up to a limit of only 30 percent of the donor's adjusted gross income ("AGI"). For some donors, this can delay or dilute the value of the deduction. By contrast, in a situation such as Ms. E's in the example above, if a donor uses cash received from a GRAT to make an outright charitable gift, the associated deduction can be used up to a limit of 50 percent of the donor's AGI.

Another advantage of having a donor establish a GRAT and then use some or all of what he or she receives from the GRAT to make charitable gifts exists with respect to long-term appreciated securities. To the extent the trust owns such securities – and regardless of whether they were used by the donor to fund the trust or whether they represent successful investments made by the trustee – they can be distributed to the donor in fulfillment of the annuity payment obligation. At the time the securities are distributed, the donor is not taxed on any of the long-term capital gain and takes over the trust's cost basis in the securities (which, in the case of securities used by the donor to fund the trust, would be his or her own original cost basis). This leaves the donor free to use the securities to make direct transfers to one or more charitable organizations, meaning that the donor receives an income tax charitable deduction for the full value of the securities but does not pay tax on any of the appreciation. Of course, the deductions associated with such transfers would be subject to a 30-percent-of-AGI limit.

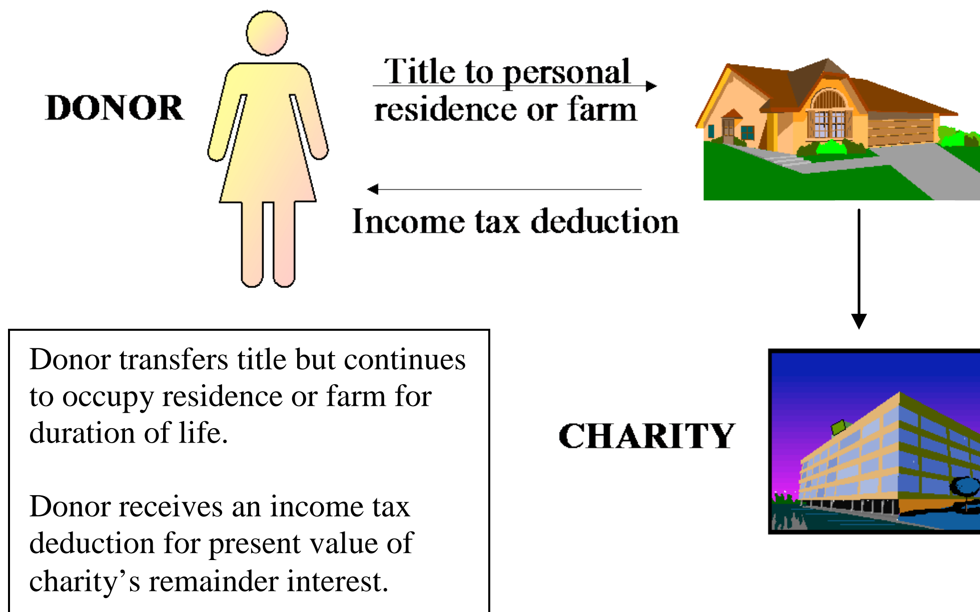
Situation Six

Along with her late husband, Mrs. F, age 82, purchased her home 43 years ago. It has recently been appraised for $500,000. The land is worth $200,000 and the improvements are worth $300,000. The appraiser considers the improvements to have a useful life of 40 years and a salvage value of $25,000. Mrs. F would like to continue living in the home for the duration of her life and assure that it then goes to a favorite charity. She would also like to reduce her taxes now.

Appropriate Gift Arrangement: A retained life estate arrangement. Mrs. F deeds the residence to the charity but in the deed reserves for herself the right to continue living in her home for as long as she lives. In return, she receives an income tax charitable deduction of $386,636. If later in life she needs to go into a nursing home or moves out of the residence for some other reason, she will have these options:

- Rent the property and retain the rental income.
- Contribute the life tenancy to the charity and receive a second deduction.
- Contribute the life tenancy to the charity for a gift annuity or to a charitable remainder trust.
- Sell the property, with the proceeds allocated between her and the charity.

<u>Brief Overview</u>



A tenancy agreement, as well as a deed, should be executed in connection with the gift. The agreement spells out the rights and responsibilities of the life tenant(s) and the charity, including who is responsible for taxes, insurance, maintenance, utilities, and major repairs/improvements.

There is no gift or estate tax if the donor or donor and spouse are the only life tenants. The donor makes a taxable transfer if the life tenancy is for someone other than or in addition to the donor or spouse. If the donor is survived by a non-spouse tenant, and the donor has retained but not exercised the right to revoke by will that person's life interest, the value of the tenancy, computed as of the date of the donor's death, is included in the donor's estate.

<u>Likely Donors</u>

- Individuals mid-60s and up.
- Those who have made provision for or are considering giving the property to charity under their will.

- Those who want to continue living in their home.

- Those in higher tax brackets in need of a deduction.

- Those who would like to continue living in their home and receive payments (combination of retained life estate gift and a gift annuity).

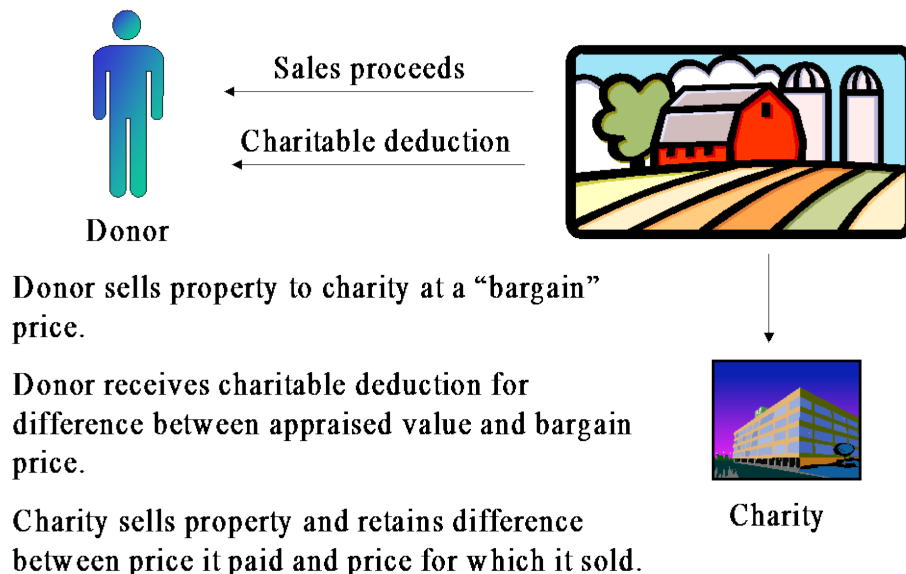
Note: All other things being equal, the lower the federal discount rate, the higher the charitable deduction associated with a retained life estate arrangement.

Situation Seven

Mr. G owns a piece of vacant land appraised at $100,000 that he acquired some years ago for $25,000. He would like to give it to his church, but he is financially unable to do so unless he receives some money in return.

Appropriate Gift Arrangement: A bargain sale. If Mr. G sells the land to the church for $40,000, he will receive an income tax charitable deduction of $60,000. He will be taxed on $30,000 of the gain but avoid tax on $45,000 of the gain. This is because his cost basis is prorated between the gift portion and the sale portion.

Brief Overview



The donor must indicate in the gift instrument or in another document related to the transaction that he or she is selling an asset to the charity at a reduced price with the intention of making a charitable gift. Bargain sales are typically used with assets such as real estate that are not easily divisible into readily marketable units.

The charity can pay the bargain sale price in installments rather than in a lump sum. This prevents the charity from having to advance a large amount from its general funds, and it prevents the donor from recognizing the gain all at once. Instead, the gain is reported ratably over the life of the installment contract. In addition, a portion of each year's payments is deemed to be taxable interest.

Likely Donors

- Individuals who cannot afford to contribute all of a particular asset, especially if the asset is not easily divisible.
- Individuals willing to make a gift if they can recover their cost. (Bargain sale price equals cost basis.)
- Anyone who would like to reduce their income tax.

Life Insurance Options

1. Using a policy to make a charitable gift

The following ways of giving life insurance are listed in order of their value to the charity. In each instance, the tax benefits and the likely prospects for that type of insurance gift are noted.

A. Transfer Ownership of Paid-up Policy

Value to the charity. A gift of a paid-up policy is equivalent to an outright gift of cash, for the charity can, if it chooses, immediately surrender the policy for cash. More likely, it will retain the policy until the insured individual dies and then collect the death benefit. Meanwhile, the cash surrender value may continue to grow.

Tax benefits. The donor is entitled to an income tax charitable deduction for the *lesser* of (1) the replacement value (the current single premium cost of purchasing a policy with equivalent coverage) or (2) the adjusted cost basis (total premiums paid reduced by any dividends paid plus the portion of each premium paid that is required for the term death benefit). Unless the considerations addressed in Revenue Rulings 2009-13 and 2009-14 apply, a life insurance policy is not to any extent a capital asset, such as securities or real estate, but rather strictly an ordinary income asset. If a policy owner were to surrender a paid-up policy, the gain is potentially subject to a federal income tax rate as high as 35 percent, whereas if he or she were to sell long-term appreciated stock, the gain would be taxed at a maximum federal rate of 15 percent. When an ordinary income asset such as a paid-up life insurance policy is donated to a charity, the donor is not taxed on the gain, but the charitable deduction is limited to the adjusted cost basis. The insurance company can provide the adjusted cost basis.

Example: *Mr. H gives the charity a paid-up policy with a face value of $100,000 and a replacement value of $48,000. His adjusted cost basis in the policy is $25,000.*

Income tax charitable deduction	*$25,000*
Tax on gain	*– 0 –*
Value to the charity	*$48,000*

If he had surrendered the policy and given the proceeds, he would have been entitled to a charitable deduction of $48,000, but he would have had $23,000 of gain taxed as ordinary income. Assuming he could have used the entire deduction in both cases, the tax consequences would have been the same.

Prospects. Some individuals purchased policies years ago to provide family protection when their children were young, or to back a loan taken out to start a new business. Now the children are grown, the loan has been repaid, and they have achieved financial security. The policy, meanwhile, has been paid up and is essentially an idle asset. Such persons are good prospects for a charitable gift of a paid-up policy.

B. Transfer Ownership of an Existing Policy on Which Premiums Are Still Owing

Value to the charity. If the policy is whole-life and has been in force for two or more years, it will likely have some cash value which is accessible to the charity. Assuming the donor continues to pay the premiums, the cash value will increase each year, and the charity will eventually collect the death benefit if it retains the policy.

Tax benefits. Subject once again to the potential applicability of Revenue Rulings 2009-13 and 2009-14, the donor is entitled to an income tax charitable deduction for the interpolated terminal reserve value (cash value plus any prepaid premiums), as well as additional deductions for subsequent premium payments. If the interpolated terminal reserve value exceeds the donor's adjusted cost basis (which could happen if the policy has been owned for a number of years), the deduction is limited to the adjusted cost basis. The donor is entitled to a deduction for each premium payment regardless of whether the donor makes a contribution to the charity, which uses it to pay the premium, or the donor pays the premium directly to the insurance company. If the first option is selected, the donor could contribute long-term appreciated securities instead of cash, thereby getting the double benefit of a charitable deduction plus avoidance of tax on the capital gain.

Example: *Ms. I gives the charity a policy she has owned for six years. It has a face value of $100,000 and an interpolated terminal reserve value of $5,400. Each year, she makes a contribution to the charity equal to the $1,200 annual premium. She receives an initial charitable deduction for $5,400 plus a deduction of $1,200 each year for the contributions used to cover the premiums. The insurance company can provide the interpolated terminal reserve value as of a certain date.*

Prospects. Individuals who conclude that their other investments are sufficient to meet family and business needs might be willing to give an existing policy. It may, in fact, be

the best way for them to make a charitable gift without impairing other assets intended for family members. Some individuals may not wish to give the entire policy to the charity, particularly if it is large. When a donor has a larger policy (say $500,000), the life insurance company may allow the owner to split the policy into two policies (say one $400,000 policy and one $100,000 policy). The donor can then give one policy to the charity and keep the other policy to meet family needs.

C. Purchase a New Policy, Initially Naming the Charity as Owner

Value to the charity. Although the policy has no initial cash value, whole life or universal life policies will accumulate cash value, and all policies will pay a death benefit if the insured dies while the policy is in force.

Tax benefits. The donor is entitled to an income tax charitable deduction for premiums paid to the insurance company after ownership has been transferred to the charity and, of course, for any contributions made to the charity to cover the premiums. The donor should either name the charity as owner on the application or pay the minimum premium required before transferring ownership. If the donor is the initial owner, pays an entire year's premium, and then transfers ownership, the initial charitable deduction will be limited to the cash surrender value, which will likely be zero. A charitable deduction is allowed for the full amount of the premium paid after the charity is named as owner.

Example: *Mr. J, age 40, would like to contribute $100,000 to the charity's endowment, but he has no substantial capital assets other than the equity in his home and his 401(k) retirement funds. He purchases a universal life insurance policy with a face value of $100,000, naming the charity as owner, and pays premiums of $2,000 per year for 10 years, after which the policy is expected to be paid up.*

Total premiums paid	*$20,000*
Total charitable deduction	*20,000*
Tax savings (28% tax rate)	*5,600*
After-tax cost of policy	*$14,400*

The amount of death benefit the charity receives depends on the investment return on the premium deposits. If the return exceeds expectations, the death benefit received by the charity could exceed $100,000. If the return is below expectations, some additional premium payments could be necessary to sustain the policy.

Prospects. Individuals who want to assure a major future gift, but cannot afford a large outlay of capital, may be willing to purchase a new policy and make the charity the owner. They can pay for their gift on the installment basis, and each installment will be a tiny fraction of the eventual gift. This gift arrangement appeals particularly to individuals who are in their thirties and forties, and possibly fifties, who do not have a lot of available capital but do have some discretionary income.

D. Name the Charity as Primary Beneficiary of a Policy

Value to the charity. Provided the owner keeps the policy in force and does not change the beneficiary, the charity will eventually receive the death benefit. Beneficiary designations, like bequests, can be changed, and the charity will receive nothing if the owner substitutes another beneficiary.

Tax benefits. The proceeds payable upon death are included in the policy owner's gross estate, but an estate tax charitable deduction is allowed for the entire amount paid to a charity. Consequently, no estate tax will be payable on the proceeds received by a charity. If an individual were named as beneficiary, the proceeds would be subject to estate tax, depending on the size of the estate.

Prospects. The best prospects for this arrangement are individuals who either have no heirs or have otherwise provided for their heirs, but who want to retain access to the cash value if they should need it, and to retain the right to name a different beneficiary should family circumstances change. They could name the charity as beneficiary of a whole-life, universal life, individual term, or group term policy. Where group life insurance is provided by an employer, and it is not an essential part of the employee's estate plan, the employee may be willing to make the charity the beneficiary if this option is brought to his or her attention.

E. Name the Charity as a Co-Beneficiary to Share the Death Benefit with Others. (The other beneficiaries could be either individuals or charities.)

Value to the charity. The potential benefit for the charity is less than if it were named sole beneficiary, but it may still receive a significant amount if it remains a beneficiary and the policy continues in force.

Tax benefits. The estate of the policy owner/insured is entitled to an estate tax charitable deduction. This will be reduced if the charity receives only a fraction of the death proceeds, and individual heirs receive the rest.

Prospects. Individuals who name the charity as a co-beneficiary, rather than sole beneficiary, may have other charitable commitments or family responsibilities for which a portion of the death benefits is needed.

F. Name the Charity as a Contingent Beneficiary to Receive the Death Benefits Only If the Primary Beneficiary(ies) Is(Are) Not Living

Value to the charity. When there is a primary beneficiary who is much younger than the insured, the charity has a remote chance of receiving anything. Still, there are instances when the primary beneficiaries do predecease the insured, and the charity does receive a significant amount.

Tax benefits. The estate of the policy owner/insured is entitled to an estate tax charitable deduction in the event that the charity receives the death proceeds.

Prospects. Some individuals, at their present stage of life, feel that all of their assets, including life insurance policies, are required to provide financial security for family members. However, they are willing for the charity to be the default beneficiary in the unlikely event that all family members predecease them or the entire family is "wiped out" in a disaster. Even though the charity would prefer to be a primary beneficiary, it should gratefully acknowledge a contingent beneficiary designation. A donor who feels appreciated for such a designation may take steps to assure a charitable gift as family responsibilities diminish and the estate grows.

2. Acquiring a policy in order to facilitate a charitable gift

Some individuals would like to make a major gift but hesitate to diminish the legacy intended for children (or other heirs). Sometimes it is possible to use a life insurance policy to replace the donated asset and save taxes in the process. Consider the following examples.

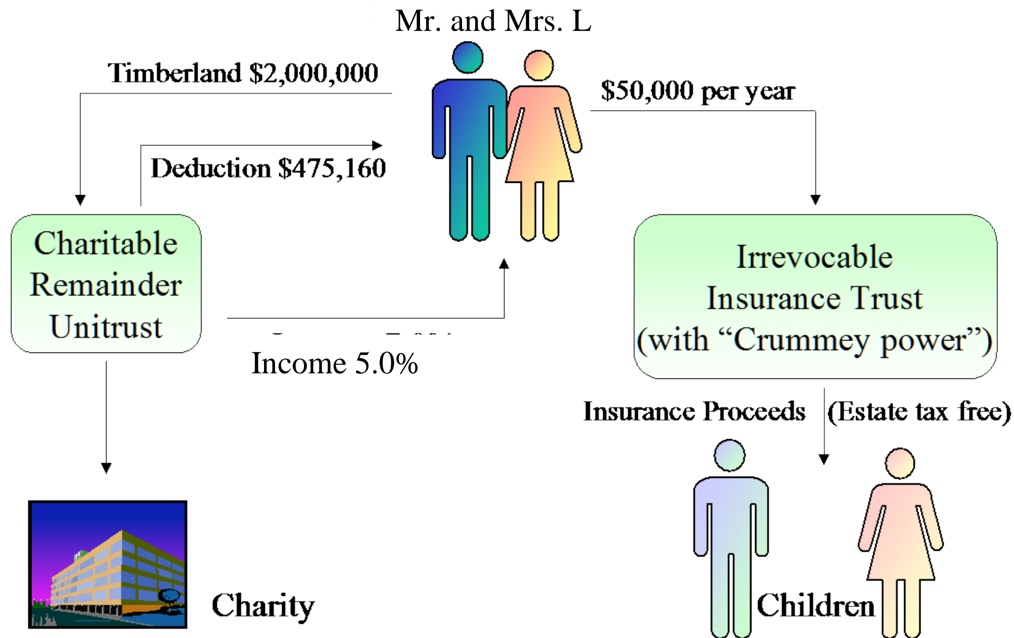
A. Wealth Replacement Life Insurance with an Outright Gift

Example: *Mr. K would like to give a parcel of real estate to the charity, but he hesitates to diminish the legacy intended for his children. He contributes the property, appraised at $250,000, to the charity and saves $87,500 in income taxes over the next few years, during which he uses the deduction. He purchases a $250,000 life insurance policy on his life and makes his children the owners and beneficiaries. Each year he gives a portion of his income tax savings to them and they use these dollars to pay premiums on the policy. At his death the children will receive $250,000. (Note: Mr. K must live three years for the death proceeds not to be included in his estate. If an irrevocable life insurance trust (ILIT) were the owner and beneficiary of the policy, the proceeds would not be included in Mr. K's estate even if he died within three years. He would make annual gifts to the trust and the trustee would pay the premiums. At his death, the proceeds would be paid to the trust, whereupon trust assets would be distributed to the children, and the trust would terminate.)*

B. Wealth Replacement Life Insurance with a Charitable Remainder Trust

Example: *Mr. and Mrs. L, both age 60, own timberland with a value of $2,000,000 and a cost basis of $200,000. They would like to make substantial gifts to several charities, receive life income for themselves, and not diminish the children's legacy. They accomplish these objectives by transferring the timberland to a charitable remainder unitrust with a 5-percent payout rate and establishing an irrevocable life insurance trust with a "Crummey power," naming the children as beneficiaries of the life insurance trust. Each year Mr. and Mrs. L use some of the after-tax income from the unitrust to make gifts to the life insurance trust to cover the premiums associated with a second-to-die policy.*

Unitrust With Wealth Replacement Life Insurance Trust



<u>Dispositions of Income Interests in Charitable Remainder Trusts</u>

Even though a charitable remainder trust is an irrevocable arrangement, a beneficiary's income interest in such a trust is an asset which, in certain circumstances, he or she can use in a way that modifies or terminates the arrangement.

1. "Cash out" the income interest and terminate the trust.

a. Per IRC Sec. 1001(e)(1), the income interest is a capital asset with a zero basis. Thus, even if cash is distributed by the trustee, all of what the income beneficiary receives will be taxable as long-term capital gain in the year of the disposition.

b. See for example PLRs 200127023, 200725044, and 200733014. If the trust's charitable beneficiary is a private foundation, however, then early termination of the trust would be a prohibited act of self-dealing.

2. Contribute the income interest to the charitable remainder beneficiary, thereby terminating the trust under the doctrine of merger.

a. The contribution qualifies for income and gift tax charitable deductions (although in the case of certain income-exception method unitrusts, there may be a gift tax problem, as noted in 5. d. below).

b. If the income tax charitable deduction is more than $5,000, there must be a qualified appraisal of that interest. Also, as the income interest is a long-term capital gain asset, the deduction will be subject to the 30-percent-of-AGI ceiling (assuming the income interest was created more than a year ago).

c. There is no partial interest problem (so long as the trust was not established initially with the intention of getting around the partial interest rule) because the income beneficiary is giving "an undivided portion" of what is now his or her entire interest. See IRC Sec. 170(f)(3)(B)(ii).

d. See Rev. Rul. 86-60 and PLRs 9409017, 9529039, 9712013, 9721014, 200010035, 200124010, 200207026, 200310024, and 200525014.

3. Contribute the income interest to the charitable remainder beneficiary in exchange for a charitable gift annuity (or use it to establish a new charitable remainder trust).

a. This is possible only if the charity in question issues gift annuities, something that is not possible in Washington unless the charity has received a "certificate of exemption" from the Office of the Insurance Commissioner. (An exception is made for the University of Washington, Washington State University, and certain other public universities.)

b. The difference between the present value of the income interest in the trust and the present value of the annuity to be paid by the charity will qualify for income and gift tax charitable deductions. A qualified appraisal will be required if the deduction exceeds $5,000.

c. So long as the charity keeps in its state-mandated gift annuity reserve account all of the assets it receives from the trust, it should be possible for the gift annuity rate to be applied to that amount, rather than to simply the present value of the income interest. Nevertheless, the amount of the annuity (as a percentage of the value of the assets received from the trust) should not exceed the charity's normal rate for an annuitant the age of the income beneficiary, plus the present value of the annuity must be less than 90 percent of the value of the income interest.

d. In figuring the taxation of the annuity payments, the income interest's zero basis needs to be taken into account.

e. See PLR 200152018. Note that the gift annuity agreement will need to contain some specific provisions.

f. Although not addressed by the IRS in any ruling to date, it should be possible for the income interest in an existing charitable remainder trust to be used as the funding asset for a new charitable remainder trust. The remainder beneficiary of the first trust,

upon purchasing from the second trust the income interest associated with the first trust, would own all assets in the first trust, which would thereupon terminate. The second trust would then have cash available for use in investing in assets suitable for the objectives of the second trust.

4. Dispose of less than all of the income interest.

a. Cashing out part of the income interest should be possible.

b. A portion of the income interest can be given to any charity, but if a charity is not also the remainder beneficiary, the donor would not receive an income tax charitable deduction. Such a donor would probably do better by continuing to receive the entire payment from the trust and then simply making outright gifts. Various private letter rulings support different ways to go about contributing to charity less than all of the income interest. See PLRs 9712013, 200140027, 200207026, and 200310024.

c. A portion of the income interest can be used to fund a gift annuity, although this makes sense only if the charity issuing the annuity is also the remainder beneficiary of the trust.

5. Miscellaneous Considerations

a. A spendthrift provision or some other element of the trust instrument may make a certain disposition difficult or impossible. See PLRs 200010035 and 200034019. To some extent, a nonjudicial agreement among the parties executed pursuant to R.C.W. 11.96A.220 may serve to nullify the effect of a spendthrift clause.

b. Depending on the type of disposition, the document by which it is implemented might take the form of an assignment, an agreement among relevant parties, or something else.

c. In many cases, dispositions will be possible even if there is more than one charitable remainder beneficiary or if no remainder beneficiary is vested, so long as proper steps are taken first.

d. Similarly, some disposition options remain available even if more than one person has an income interest, although – in certain situations – there can be a gift tax trap for income-exception unitrusts with more than one noncharitable beneficiary. See PLRs 9529039, 9550026, and 9721014.

e. Another wrinkle in the case of income-exception unitrusts is that the payout rate used in calculating the present value of the income interest may need to be reduced to something below the nominal rate set forth in the trust instrument, especially during a period such as the current one when the federal discount rate is quite low. PLRs 200725044 and 200733014 address this, along with the advisability of the beneficiary documenting that he or she does not have a shorter than average life expectancy.

f. Certain dispositions may require the involvement of a court or of the Office of the Attorney General.

g. To the extent assets are distributed in-kind to more than one beneficiary of the trust, the trustee will likely need to make such distributions pro rata or in some other manner that fairly reflects of the adjusted cost basis of the assets held by the trust.

h. Care will need to be exercised in winding up the trust if the disposition results in its termination. For example, all trust assets and income earned on those assets will need to be accounted for; there may be a final CRAT or CRUT payment to be made; and the trust's final tax return will need to reflect what has taken place.

i. When in doubt, obtain a private letter ruling!

Dispositions Involving Other Part Charitable/Part Noncharitable Arrangements

1. Charitable Gift Annuities

In many cases, it is possible for an annuitant either to cash out his or her interest or to surrender it to the issuing charity. The latter is almost always done on an outright basis, although it is theoretically possible for the annuity interest associated with one gift annuity to be used to establish a second gift annuity.

2. Pooled Income Funds

It should be possible for a pooled income beneficiary to cash out his or her income interest. He or she could also contribute it to the charity that maintains the fund, either on an outright basis or in exchange for a gift annuity.

3. Retained Life Estates

It may be that a donor who has contributed a personal residence or a farm to a charity and retained a life estate in the property will, in time, want to dispose of the life estate. The donor could agree with the charity to sell the property, with the two parties then dividing the proceeds according to their actuarial interests as determined on the date of the sale. Alternatively, the donor could contribute the life estate to the charity, either on an outright basis or for a gift annuity.

4. Charitable Lead Trusts

In certain circumstances, a charity can cash out its interest in a charitable lead trust, thereby accelerating the distribution of whatever assets are left to the noncharitable remainder beneficiaries.