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Spring 2008 Newsletter

Options for Charitable Giving

Recent news headlines demonstrate the growing trend of charitable giving by the rich and famous, including Bill Gates, Warren Buffet, Baron Hilton, Oprah Winfrey, and Michael Bloomberg just to name a few. However, acts of charitable giving are not limited to the rich and famous. Individuals of all economic backgrounds are increasingly choosing to make charitable gifts both during life and at death.

In addition to the benevolent reasons to engage in charitable giving, there may be tax benefits. With careful planning, a donor's charitable gifts can reduce his or her potential income tax, gift tax, and/or estate tax liabilities. This article summarizes the rules and tax implications for some of the most common alternatives for making charitable gifts both during life and at death.[1]

Lifetime Gifts vs. Testamentary Gifts

Different benefits and drawbacks apply depending on whether the donor chooses to make a charitable gift during life (*i.e.*, a lifetime gift) or at death (*i.e.*, a testamentary gift).

If itemizing, lifetime charitable gifts will usually result in a deduction to the donor's income tax liability for the year of the gift. However, the IRS limits the deduction for lifetime charitable gifts in any one taxable year to a specific percentage of the donor's adjusted gross income (AGI).[2] The maximum amount of a donor's charitable deductions in any one year ranges from 50% to 20% of the donor's AGI, depending on several factors, such as: (A) The type of charitable recipient (*i.e.*, public charities vs. private foundations); (B) The type of property donated (*e.g.*, cash, long-term capital gain property, short-term capital gain property, ordinary income property, or tangible personal property); (C) Whether the donor makes a specific election with respect to long-term capital gain property donated to public charities; and (D) Whether the gift is made "to" the charity, or "for the use of" the charity. To the extent a donor has charitable contributions in any tax year in excess of the percentage limitations, the donor may carry over the excess for the five succeeding tax years.

Lifetime gifts also have a related estate tax benefit in that the gifted property will generally be removed from the donor's estate prior to death. On the other hand, in addition to the percentage limitations discussed above, a primary drawback of lifetime charitable giving is that the donor must relinquish immediate ownership and direct control over the gifted property.

In contrast to a lifetime gift, testamentary charitable gifts will not deprive the donor of ownership, control, or use of the asset during the donor's lifetime. There are also no limitations on the amount of the deduction for testamentary gifts. Testamentary gifts result in a deduction to the donor's estate tax liability,[3] but not a deduction to the donor's income tax liability.

> **IN FAITH AND HOPE THE WORLD WILL DISAGREE, BUT ALL MANKIND'S CONCERN IS CHARITY.**
>
> ALEXANDER POPE
> ESSAY ON MAN

Public Charities

A donor may wish to simply make a lifetime gift or testamentary gift directly to a public charity. Generally, organizations that are classified as public charities are those that: (A) are churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges and universities; (B) have an active program of fundraising and receive contributions from many sources, including the general public, governmental agencies, corporations, private foundations or other public charities; (C) receive income from activities in furtherance of the

organization's exempt purposes; or (D) actively function in a supporting relationship to one or more existing public charities.

The primary benefit of making a lifetime charitable gift to a public charity is that there are higher percentage limitations available for income tax deductions. The primary drawback of making any charitable gift to a public charity is that the donor has little or no control over how the charitable gift will be applied by the public charity after it is donated.

Private Foundations

A private foundation is a charitable organization created, funded, and usually controlled by a single donor or by members of the donor's family. In contrast to a public charity, gifts to a private foundation can provide a higher degree of long-term control and flexibility to a donor in terms of how the charitable gift will be applied to charitable purposes. Another benefit of a private foundation is that the donor can involve future generations of his or her family in the ongoing operation of the foundation. Drawbacks to creating a private foundation include potentially higher administrative costs, more restrictions on the expenditure of funds, and the constant exposure to excise taxes (which can be imposed on both the foundation and its manager) if the foundation fails to stay within the strict private foundation rules (described below).

Private foundations are not necessarily complicated to create. However, maintaining a private foundation is a significant undertaking, which the donor should understand before creating the private foundation. Private foundations must comply with strict IRS rules restricting the foundation's operations, investments, and disbursements. Penalties apply for failure to comply with these rules. Therefore, donors considering creating a private foundation should consider hiring professional assistance to ensure that the foundation meets all of the regulations and requirements.

The following are some examples of the operating requirements for a private foundation:

- Each year a private foundation must make qualifying distributions equal to at least 5% of its average net investment assets. This requirement can be difficult to meet if a private foundation does not have sufficient liquid assets to distribute each year. An excise tax is imposed if the distribution requirement is not met.
- There are restrictions on the choice of recipients of distributions from a private foundation. Any non-permitted "taxable expenditures" are subject to a penalty tax.
- Strict self-dealing rules also apply. For example, a private foundation cannot sell or lease real property to, buy or lease real property from, or exchange real property with, a "disqualified person." The definition of a "disqualified person" is broad and includes, among others, a "substantial contributor" to the foundation and his or her family members. There are also strict rules regarding the payment or reimbursement of expenses by the foundation.
- There are limitations that apply to the percentage of ownership interests that a foundation can hold in an active business entity, especially when "disqualified persons" also hold ownership interests in the entity.
- Private foundations are prohibited from holding "jeopardizing investments," which can include such assets as working oil and gas interests, puts, calls and securities traded on margin.

The income tax deductions available for lifetime contributions to private foundations are also more limited than for contributions to public charities. For example, cash gifts to a private foundation are only deductible up to 30% of AGI (as opposed to a 50% of AGI limitation for similar gifts to public charities).

Donor Advised Funds

Another charitable option is to make gifts to a donor advised fund of an existing community foundation. A donor advised fund is a charitable plan where the donor makes the gift directly to a community foundation (which is categorized as a public charity for purposes of the donor's income tax deduction percentage limitations). The community foundation will then set up a sub-account or fund in the donor's name to hold the gifted property. The donor, or a person appointed by the donor, can make recommendations of grants to be paid from that fund to selected eligible charitable beneficiaries (*i.e.*, the donor has some input in how the contributed assets will be applied to the ultimate charitable beneficiaries).

In general, gifts to a donor advised fund allow the donor to obtain some of advantages of control similar to those of a private foundation without the regulatory hassles, expense, lower deduction limitations and increased compliance rules. Another benefit of setting up a donor advised fund is that the donor receives an immediate charitable deduction for income tax purposes, even if grants from the fund are spread out over many years. The primary disadvantages of a gift to a donor advised fund are the potential grant restrictions that may be imposed by the community foundation (*e.g.*, geographic restrictions), and a limitation on the donor's right to complete control of the management and distribution of the fund (*i.e.*, the donor may make grant *recommendations* to the community foundation, but the community foundation has *ultimate control*, known as a variance power, over the fund).

★ ★ ★ ROLL CALL ★ ★ ★

On February 15, **Tom Stover** presented a CLE program on marital deduction planning in Denver. On March 26, he presented a program on advising beneficiaries of Generation Skipping Transfer (GST) Trusts to the Boulder County Bar Association. He will also present this program at the Colorado Bar Association's annual Estate Planning Retreat in June. He attended the annual meeting of the American College of Trust and Estate Counsel (ACTEC) in Boca Raton, Florida, where he is a member of the Practice Committee.

Jennifer Spitz gave a presentation for the Colorado Bar Association (CBA) last November on the topic of estate planning in this uncertain estate tax environment. She is reprising that presentation for the CBA this June at the Trust and Estate Section's Estate Planning Retreat. She also published an article on a similar topic for the December 2007 issue of the Boulder County Bar Association's newsletter.

David Brantz is enrolled in the University of Denver's Sturm College of Law Graduate Tax Program and is working towards obtaining his LL.M. (Master of Laws) in taxation. David most recently completed the ten-week Estate and Gift Tax course of the Graduate Tax Program, and continues to stay active in the meetings of the Boulder County Bar Association's Trust and Estates Section.

Charitable Remainder Trusts (CRTs)

The basic premise behind a charitable remainder trust (CRT) is that the donor makes an irrevocable gift of property to a trust which provides a current benefit to a named individual or individuals (collectively the "income beneficiary") for a certain term of years or for the life of the income beneficiary, with the remainder of the trust passing to one or more charities at the end of the trust term. Certain variables, such as the income beneficiary's age, the payout rate to the income beneficiary and the trust term, are taken into account in determining the value of the charity's remainder interest. Generally, a lower payout rate results in a higher charitable deduction because, actuarially, greater assets eventually will pass to the charity. A CRT can be created in conjunction with a private foundation such that the foundation could be named as the remainder beneficiary.

One drawback of using a CRT is that it will be treated much like a private foundation, including the prohibition of self-dealing (*i.e.*, the CRT may not enter into sales, leases, loans, or certain other transactions with the donor or related parties).

A CRT can be created during life (a lifetime CRT) or at death (a testamentary CRT). With a typical lifetime CRT, the donor or the donor's spouse would be the sole income beneficiary. In such situations, no estate or gift tax would be due on the assets passing to the CRT[4] and the donor could take an immediate income tax charitable deduction for the present value of the remainder interest passing to the charity.

With a testamentary CRT, the donor would name someone else as the income beneficiary. For example, a donor could establish testamentary CRTs for his or her children. In that case, the donor would receive an estate tax charitable deduction for the actuarial value of the remainder interest passing to the charity, but the value of the interest passing to the donor's children would be subject to estate tax.

In addition to the income and gift/estate tax deductions, a CRT can enhance the donor's investment return. Because the CRT pays no income taxes,[5] the CRT can generally sell an appreciated asset without recognizing any gain. This enables the trustee to reinvest the full amount of the proceeds, and thus, generate larger payments to the income beneficiary. Therefore, if a donor were to create a lifetime CRT, he or she should consider transferring low-basis property to the CRT in order to take full advantage of the CRT's income tax free status.

Charitable Lead Trusts (CLTs)

In some respects a charitable lead trust (CLT) is the opposite of a CRT. A charity is named as the beneficiary of the trust for a certain number of years, with the remainder passing to one or more individuals. The charitable interest can be for a certain term of years or tied to the life of an individual within a narrow group. As with a CRT, a CLT could be created in conjunction with a private foundation such that the foundation would be given the lead interest in the CLT.

Lifetime CLTs are not commonly used due to the fact that an income tax deduction is generally not available for transfers to a CLT. However, an estate tax charitable deduction (for testamentary CLTs) is available for the actuarial value of the charity's "lead" interest.

Conclusion

A number of common alternatives exist for making charitable gifts both during life and at death. With careful planning, a donor's charitable gifting can meet with the donor's charitable intent while also maximizing the donor's potential to reduce income tax, gift tax, and/or estate tax liabilities.

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[1] This article specifically discusses the difference between lifetime gifts and testamentary gifts, and options for gifting via public charities, private foundations, donor advised funds, CRTs and CLTs. Other alternatives, such as charitable gift annuities and qualified conservation contributions, are also available for charitable giving.

[2] Please note, under the Internal Revenue Code (IRC), income tax deductions are limited to a percentage of the donor's "contribution base," which is defined as the donor's AGI computed without regard to any "net operating loss carryback." "Net operating loss carryback" is a rare occurrence for most taxpayers, so for purposes of this article we refer to the income tax deduction limitations as a percentage of AGI.

[3] In 2008, an individual who made no taxable gifts during life could only be subject to federal estate tax if the individual's gross estate is valued at more than $2,000,000.

[4] Gift tax liability may arise if a donor creates a lifetime CRT with one or more income beneficiaries who are persons other than the donor or the donor's spouse.

[5] Although the CRT does not pay income taxes, the income beneficiary would be taxed on distributions made from the trust.

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