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CHARITABLE PLANNING – A PRIMER
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Planning for charitable gifts and bequests by inter vivos documents, wills, trusts, beneficiary designations and otherwise requires careful attention to various sets of rules. We need to take into consideration the federal tax rules in connection with charitable deductions for the federal income, gift and estate tax, the state law requirements for gifts, bequests, trusts and the designation of beneficiaries, as well as the goals and desires of the donor.

INCOME TAX CHARITABLE DEDUCTION. The federal income tax aspects of charitable planning deal with both the qualification for the income tax charitable deduction as well as the limitation on the amount currently deductible. [1] The income tax charitable deduction for an individual donor is subject to limitations depending upon a number of factors, including but not limited to the contribution base of the donor, the type of item contributed and the value of the contribution. The donor's contribution base is typically the donor's adjusted gross income. [2] The general rule for the income tax deduction is that a charitable gift is deductible in an amount up to 50% of the contribution base in any year, for contributions to a public charity that are made in cash or non-appreciated property. Contributions to 50% or public charities are limited to 30% of the contribution base if the asset contributed is appreciated property.

Charitable organizations that do not qualify as 50% charitable organizations are 30% charitable organizations with different charitable deduction limitations. Contributions to 30% charitable organizations are currently deductible up to 30% of the contribution base, but if the asset contributed is appreciated property, the deduction is limited to 20% of the contribution base.

Contributions that exceed the above deduction limitations generally may be carried over for deduction in the next five (5) succeeding years giving the donor a total of six (6) years to take the deduction, with the same limitations in the carryover years. It is also important to note that if the donor dies with unused carryovers, they are lost and cannot be used by donor's estate.

Note that there is no charitable deduction for New Jersey income tax purposes.

There are no percentage deduction limitations for the gift and estate tax charitable deductions. The full amount of the charitable component of the gift or bequest to charity is deductible for gift or estate tax purposes, respectively, so long as they are qualifying interests. [3]

FORMS OF CHARITABLE GIFTS. The following are some of the forms of charitable gifts that can be made during the donor's lifetime or upon the donor's death.

Outright Gifts, Bequests and Transfers. outright transfers of cash, tangible and intangible personal property, and real property are deductible for income, gift and estate tax purposes in the amount of the fair market value of the item gifted, subject to certain limitations. [4] There are special rules applicable to gifts of tangible personal property that are made by gifts of partial interests from time to time greatly restricting the use of that method of gifting. [5]

<u>Bargain Sales.</u> Another method of benefiting charity currently is a sale by the donor to the charitable organization for less than the fair market value of the property, or a bargain sale. [6] A sale of a capital asset to charity for a price less than the fair market value of the asset is treated as a part sale and part gift. The donor will have taxable gain in the amount received on the sale portion reduced by the allocable share of the basis in the asset sold. The donor will have a charitable contribution in the amount of the fair market value of the property transferred reduced by the amount realized on the sale.

<u>Split Interest Gifts.</u> There are several types of transfers to a combination of charity and individuals which qualify for the income, gift and estate tax charitable deduction. These split interests may also be paired with marital planning and the marital deduction. If the transfer is not in one of the specified forms, no charitable deduction will be allowed, even though there is an actual transfer to a charity at some time. These forms include the following: charitable lead trusts, remainder interest in personal residence or farm, remainder interest in pooled income funds, charitable gift annuity, charitable remainder annuity trusts and charitable remainder unitrusts.

<u>*Charitable Lead Trust*.</u> A charitable lead trust ("CLT") is a trust from which a charity (or charities) receives a fixed dollar amount (annuity) or a fixed percentage of the net fair market value of the trust assets (unitrust) annually, and upon the end of a term of years or upon the death of an individual, the remainder passes to the donor or another non-charitable beneficiary (or beneficiaries). [7] There is no minimum percentage that must be paid to charity so long as the trust payment is in the form of an annuity or unitrust amount. However, the amount must be paid at least annually to the charity. The trust cannot provide that the charity is to receive all the income, or any other provisions other than an annuity or unitrust to obtain the income, gift and estate tax benefits of the CLT. The term of the trust may be for any number of years or may be measured by the life or lives of individuals alive at creation of the trust.

The donor may or may not be entitled to an income tax deduction for the actuarial value of the annuity or unitrust interest on the date of funding of the trust, depending on the form of CLT.

Whether the income tax deduction is available or not, a gift tax charitable deduction is allowed in the amount of the actuarial value of the annuity interest or unitrust interest and is not limited in amount as is the income tax deduction. [8] The value is determined by the dollar annuity or percentage unitrust amount and the term of years or life expectancy using the IRS tables. The longer the term of the trust, or the larger the annuity or unitrust amount, the larger the value of the charitable interest.

The estate tax aspects of the CLT depend on the identity of the remainder beneficiaries and whether the trust is established during the donor's lifetime or upon donor's death. If the CLT is established upon the death of the grantor by will or in a trust, the estate tax charitable deduction is allowed in the amount of the value of the annuity interest or unitrust interest established in the trust, calculated as described above for income tax purposes without limitation. [9] If the remainder passes to a spouse, that gift qualifies for the estate tax marital deduction. [10]

The CLT can be used effectively in a number of circumstances. The CLT permits the transfer of assets to the individual beneficiary at a later date with a greatly reduced estate or gift tax cost, i.e. for young children or grandchildren. The lifetime CLT is useful to an individual who has high income in the year of the transfer to the CLT and not in the future, i.e. retiree, or someone with a large severance package or capital gain in a given year and lower income in the future, since it may produce an income tax deduction in the year of the transfer to the trust and taxable income in later years.

The rules and requirements of the CLT are strict and technical. The IRS has issued sample safe harbor forms for CLTs, which if followed, will provide the donor with the desired results. [11]

Remainder interest in personal residence or farm. Donor gives to charity a personal residence or farm subject to a non-charitable interest for the life of individual(s) or for a term of years. [12] The reserved life estate can be for the donor and donor's spouse so that after the first death, the surviving spouse may continue to live in the property. The amount of the deduction for income, gift and estate tax purposes is the actuarial value of the remainder interest after the life estate or term of years computed using the IRS tables for income interests in the month of the transfer.

Pooled Income Fund. [13] A pooled income fund ("PIF") is an investment fund created and maintained by a public charity (i.e. educational institution, church, hospital) which consists of property contributed by more than one donor which is commingled. Each donor transfers property to the PIF and either retains in himself or herself and/or creates for another individual a life income interest therein, thereby creating a charitable remainder interest in the sponsor charity. All property so transferred is invested together. Each donor (or donor's designated income beneficiary) receives the pro rata share of the income of the PIF each year for life or the term of years specified. On the death of the income beneficiary, (or successor individual beneficiary), or the end of the term of years, the charity withdraws the donor's share of assets from the PIF and uses them for its charitable purposes.

The transfer to a PIF has two components, namely the gift of the income interest(s) and the gift of the remainder interest to charity, calculated based on the age of the income beneficiary and the tables in the month of the transfer. [14] The value of the charitable remainder is deductible for income and gift tax purposes. The value of the income interest is a taxable gift. The donor does not recognize any capital gain upon transferring appreciated non-mortgaged assets to the PIF.

The estate tax consequences depend on several factors, including whether the transfer to the PIF was made during donor's life or on donor's death. [15] The donor's estate receives a charitable deduction for the full value of the fund passing to charity upon the death of the donor or the remainder value after the death of an income beneficiary other than the donor. [16] If the spouse is the income beneficiary, the executor can make an election [17] to obtain the marital deduction. On the spouse's death, the fund is included in the spouse's estate as a result of the marital deduction election, [18] and then the full amount is deductible as a charitable contribution in the spouse's estate. [19]

Charitable Gift Annuity. [20] Certain charities have qualified to issue gift annuities to donors in exchange for donations to the charity. The donor receives an annuity (fixed dollar amount distributed per quarter) for life (or directs the annuity be paid to another individual) and upon the death of the annuitant, any balance remaining belongs to the charity for its purposes. If the donor purchases an annuity from a charitable organization, the donor is allowed an income tax charitable deduction for the excess of the amount paid for the annuity over the value of the annuity. If there is no excess, there is no deduction. This is usually used for relatively small gifts from individuals who want or need to retain cash flow from the assets but want to irrevocably dedicate the balance to the charity, and who either are not giving enough or do not want to be bothered with a charitable remainder trust, below.

Charitable Remainder Annuity Trust and Unitrust. A charitable remainder annuity trust or unitrust is a trust from which a non-charitable beneficiary (individual) receives a fixed dollar amount (annuity) or a fixed percentage of the net fair market value of the trust assets determined each year (unitrust) at least annually, and upon the death of the income beneficiary(ies), or after the specified term of years, qualified charity(ies) receives the remainder of the trust. [21] The annual amount paid to the beneficiary cannot be less than 5% nor more than 50% of the initial fair market value of all assets placed in trust for an annuity trust, or must be a stated percentage of at least 5% but not more than 50% of the fair market value of the trust assets valued annually for a unitrust. The IRS has issued model forms for these trusts, which are very helpful in drafting these complex and technical trusts. [22]

One of the key features of the CRT is that it is exempt from federal income tax on the income earned in the trust. [23] Distributions to beneficiaries retain the income tax character to the beneficiary as the funds had to the trust in a specified priority of character, and are taxable to the receiving beneficiary even though the income would not have been taxed if it remained in the trust. [24]

CAVEAT: Until just recently, NJ has taken the informal position that the CRT is also exempt from New Jersey income tax (NJGIT) even though the statute provides that only a wholly charitable trust is exempt from NJGIT. [25] A CRT is not wholly charitable due to the annuity or unitrust interest of one or more individuals but the Division followed the federal rule informally. The NJ Division of Taxation recently announced that the CRT is not a tax exempt entity for NJGIT, contrary to its longstanding position.

If the CRT is funded during the lifetime of the donor, both the income and gift tax charitable deductions are allowed to the donor in the amount of the value of the remainder interest, calculated actuarially based on the age of the income beneficiary(ies) or the term of years, percentage unitrust or annuity, and the IRS discount rate for the month of the transfer. [26] As with a pooled income fund, the donor makes two gifts: the income interest to the individual beneficiary and the remainder interest to charity, calculated actuarially based on the age of the income beneficiary or term of years and the IRS tables so that a taxable gift may be incurred for the gift to the individual.

The estate tax consequences of the CRT depend on a number of factors, including whether the CRT was created during the donor's lifetime or upon donor's death. The donor's estate is entitled to a charitable deduction for the full value of the trust assets if the donor was the sole lifetime beneficiary, or the value of the remainder if there is another lifetime beneficiary based on the age of the lifetime beneficiary or the term of years and the amount of the annuity or percentage unitrust, leaving the beneficiary's life estate as a taxable devise.[27] If the income beneficiary is the donor's spouse, the marital deduction is allowed for the assets in the trust. [28] Note: for the marital deduction to be available, the CRT must have no non-charitable beneficiary other than the donor and spouse.

Certain Marital Trusts (qualified terminable interest property or QTIP Trust) with Remainder to Charity. A QTIP trust is a trust established for the benefit of the spouse of the donor so that all income of the trust is paid to the spouse for life and no one other than the spouse. [29] The QTIP trust may have certain other provisions, as well. Upon the death of the spouse, the balance of the trust passes as provided in the trust agreement, which may be charity or partially to charity. A QTIP trust with a remainder to charity does not qualify for the income, gift or estate tax charitable deduction for the donor. However, if the donor (inter vivos) or the donor's executor (transfer at death), makes the QTIP marital deduction election, the full value of the trust (or the portion so elected) would qualify for the gift or estate tax marital deduction. [30] On the death of the second spouse, the assets are included in the spouse's estate, [31] but that estate is allowed a charitable deduction for the portion or all of the remainder as property passing to a charity. [32]

There are certain advantages of the QTIP over the CRT for a spouse, and there are certain other benefits of the CRT over the QTIP. The income, gift and estate tax consequences as well as the non-tax aspects of each trust, such as the availability of income and principal as compared with an annuity or Unitrust amount for the spouse must be considered in deciding which is better for the particular client.

Private Foundation. The typical private foundation is established by the donor as a trust or non-profit corporation which satisfies the requirements of the Code [33] with respect to purposes but whose support is limited in the number and type of donors so as not to meet the public support tests. [34] There are many types of Private Foundations. There are very strict rules that must be observed in the operation of a Private Foundation. [35] The donor is eligible for the income and gift or estate tax deductions up front and the funds are paid out to charity or charities over many years. Private Foundations are useful in the year of high income where the donor does not want to decide which charities to give to or does not want to give the full amount in year one. The private foundation also allows for junior family members to be involved in the charitable and philanthropic activities of the senior family members and ultimately continue these activities in the name of the family.

Donor Advised Funds. Certain community foundations (ie New Jersey Community Foundation) and other organizations (ie Fidelity Charitable Services and funds maintained by certain brokerage houses) offering the equivalent of community foundations offer a type of account called a donor advised fund. The donor establishes a fund with the foundation and retains the right to the donor (and/or other specified individuals, such as spouse and children) to make requests as to the recipients of distributions from the fund from time to time. Although the donor advised fund trustee is not obligated to make the requested distributions, unless there is a compelling reason not to do so, the donor advised fund trustee usually follows the request. This is the equivalent of a simplified private foundation since the donor obtains the benefit of the administrative services of the foundation and the investment expertise for the donor's separate fund at the foundation and most, if not all, distributions are made at the request or with the approval of the donor. The other benefit of using the donor advised fund is that the foundation qualifies as a public charity and so is not subject to the private foundation rules and excise taxes, and the income tax deduction limitations for the donor are those of a public charity and not the lower limitations of gifts to a private foundation.

Special uses of CRTs and Private Foundations. If the donor has appreciated property, the sale of the asset and then donation of proceeds has significant income tax consequences to the donor very different from the donation of property and sale by the CRT. Since the CRT is exempt from federal income tax, when the asset is sold, the entire proceeds remain in the trust for reinvestment, undiminished by federal income tax on any gain upon the sale. This can be useful for diversification of holdings and to convert low basis/low income producing assets into higher yielding assets for increased cash flow – possibly to better cover expenses of an aging donor or spouse.

If the individual has substantial IRA, IRC §401(k) or other qualified plan benefits, the family may net as little as 20% after estate, inheritance, income, etc. taxes. All or a portion of the qualified benefits passing to charity outright on the death of the IRA owner by beneficiary designation results in no federal or New Jersey estate tax, federal generation skipping transfer tax or New Jersey inheritance tax, and the charity pays no income tax so that the cost of the charitable gift to the family is small in comparison to the benefit to the charity. This can be accomplished by a percentage or fractional interest in the beneficiary designation for the IRA or benefits. If all or a portion of the IRA passes to a CRT by beneficiary designation upon the death of the IRA owner, depending on the age of the individual annuity or Unitrust beneficiary of the CRT and the amount of the annuity or unitrust, the estate tax deduction may be substantial. The CRT pays no federal income tax on benefits received and reinvests the entire amount. Since the CRT pays no federal income tax, the ongoing annuity or unitrust payments to the beneficiary may be more than an outright payment in just a few years, and if the beneficiary(ies) live a long time, the additional amounts may be substantial - the beneficiaries and charities get more and only the IRS gets less

Direct Distributions from an IRA. As part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010"), signed December 17, 2010, §408(d)(8)(F) was amended to extend the IRA charitable rollover through 12/31/11, call a Qualified

Charitable Distribution or QCD. The requirements for QCD include the following: The donor must be at least 70½ years old, the donor may direct a transfer of up to $100,000 in a given year from an IRA only (not employer sponsored retirement plans, SIMPLE IRAs or SEPs) to qualified charity(ies) (ie public charities as defined in §170(c)(1)(A) other than support organizations and donor advised funds). If this is done, then the distribution amount is not included in the donor's federal taxable income and there is no charitable deduction. Distributions that are excludable under this provision are not taken into consideration in determining the deduction for charitable contributions under §170 and its limitations but they are taken into consideration as satisfying all or part of the donor's Minimum Required Distribution or MRD for the year. The QCD is better than a withdrawal from the IRA and then contribution because the QCD is not included in the taxable income with a deduction since the deduction may not fully offset the income due to things such as charitable deduction limitations, partial disallowance of excess itemized deductions for high income earners, AMT, etc.

As you can see from the above discussion, the rules applicable to charitable giving are complex and strictly enforced. Charitable giving during life and at death must be carefully planned and executed to obtain the desired tax and non-tax results for the donor, donor's family and charity.

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[1] Internal Revenue Code ("IRC") §170
[2] IRC §170(b)(1)(F)
[3] IRC §2522 (gift tax) and IRC §2055 (estate tax)
[4] IRC §170 (income tax), §2522 (gift tax) and §2055 (estate tax)
[5] IRC §170(o)(1)
[6] IRC §1011(b) and Treas. Reg. §1.170A-4(c)(2)
[7] IRC §170(f)(2)(B)
[8] IRC §2522(c)(2)(B)
[9] IRC §2055(e)(2)(B)
[10] IRC §2056(a)
[11] Rev. Proc. 2007-45 and 46, IRB 2007-29 (7/16/07)
[12] Treas. Reg. §1.170A-7(b)(3)
[13] IRC §642(c)(5) and Treas. Reg. 1.642(c)-5.
[14] IRC §2522(c)(2)(A)

[15] IRC §2055(e)(2)(A)
[16] IRC §2055(a)
[17] IRC §2056(b)(7)
[18] IRC §2044(b)
[19] IRC §2055(a)
[20] IRC §170(f)(3)(A)
[21] IRC §664
[22] Rev. Proc. 2005-52 to 59, IRB 2005-34 (8/22/05)
[23] IRC §664(c)(1)
[24] IRC §664(b)
[25] N.J.S.A. 54A:2-1
[26] Treas. Regulations under §170(f)(2)(A); IRC §2055
[27] IRC §2055(e)(2)(A)
[28] IRC §2056(b)(8)(A)
[29] IRC §2056(b)(7)
[30] IRC §2523(f) for an inter vivos transfer and IRC §2056(b)(7) for a trust upon the death of the donor
[31] IRC §2044(b)
[32] IRC §2055(a)
[33] IRC §501(c)(3)
[34] IRC §509(a)
[35] IRC §4940 et seq., i.e. no self dealing, minimum distributions, no excess business holdings, etc.