SHOULD CHARITABLE GIVING BE A PART OF MY ESTATE PLAN?

by Layne T. Rushforth

Summary

Charitable contributions not only entitle the donor to an income-tax deduction, but may also accomplish certain estate-planning objectives. Such contributions can be made as outright gifts or as gifts to trusts. The benefit to the charity or charities provides the primary motivation for most charitable giving, but significant estate planning benefits may also encourage people with larger estates to make charitable gifts. In some situations, people who may not otherwise be inclined to provide for charities find that charitable giving can reduce taxes and facilitate their overall estate-planning objectives. This memo focuses primarily on charitable trusts and outlines some of the reasons charitable trusts ***should*** be included in an estate plan, some of the techniques that ***could*** (and could not) be included, and a summary of the options that people ***do*** implement.

1. LIFETIME CHARITABLE CONTRIBUTIONS

1.1 Qualified Charities. For the purposes of this memo, all references to "charities" are references to "qualified charities" as defined under the Internal Revenue Code. IRS Publication 78, "Cumulative List of Organizations described in Section 170(c)" is a list of organizations that the IRS has ruled are qualified charities.[1] Under section 170 of the Internal Revenue Code, a qualified charity fits into one of five categories:[2]

(a) A corporation, trust, community chest, fund, or foundation organized and operated *exclusively* for charitable, religious, educational, scientific, or literary purposes, or for the prevention of cruelty to animals, or to foster and conduct amateur sports competition;

(b) A governmental entity;

(c) A war veteran's organization;

(d) A domestic fraternal society, order, or association; or

(e) A nonprofit cemetery company chartered solely for burial purposes.

1.2 Deduction Ceilings. The charitable deduction for income tax purposes is limited.

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[1] An organization's appearance or absence in IRS Publication 78 does not mean that the organization is or is not a qualified charity. Organizations are added and deleted annually.

[2] IRC § 170 contains additional restrictive qualifications not mentioned here.

(a) Most public charities are classified as "50% charities", and individuals may deduct charitable contributions to the extent they do not exceed 50% of their adjusted gross income.

(b) Certain organizations (such as war veterans' organizations, fraternal orders, and nonoperating private foundations) are classified as "30% charities", and the charitable deduction is limited to 30% of the individual's adjusted gross income.

(c) For gifts of appreciated assets (long-term capital gain property), the limitations are normally reduced to 30% (for "50% charities") and 20% (for "30% charities"), but at the time this memo was prepared, Congress had enacted a temporary law modifying this rule.[3]

(d) If a charitable contribution exceeds the deduction limitation, the unused portion can be used in up to five subsequent years, but even this depends on the type of property being contributed and the class of charity to which the contribution is made.

1.3 Cash Donations. Cash donations to a qualified charity are the simplest way of making a charitable gift. If the charity is a qualified charity, the donation qualifies for a current income tax deduction, subject to contribution limitations determined by the type of charity.

(a) If the contribution is made in conjunction with an event (such as a dinner or entertainment), the deduction is limited to the difference between the amount contributed and the value of the benefit received.

(b) Amounts paid for raffle tickets and bingo games are not charitable contributions (but they may be deductible as gambling losses that can offset gambling winnings).

1.4 Gifts of Property. Gifts of property are also deductible, but the rules that apply to contributions of property are more complex than those that apply to cash.

(a) As a rule, the deduction amount is the net fair market value of the property contributed as of the time of the contribution, and no gain must be reported if the property has appreciated.

(b) If a sale of the contributed property would have produced ordinary income (such as property held in a business inventory), the deduction is reduced, but the amount of reduction depends on certain factors, including the type of property contributed and the charitable organization receiving the contribution.

(c) The deduction for contributions of tangible personal property unrelated to the charity's "exempt function" or to certain private foundations is limited to the donor's basis.

[3] Depending on the mood of Congress, the deduction rules vary from time to time, so be sure to check with your tax counsel or your Certified Public Accountant as to the applicable laws at the time a charitable gift is contemplated.

(d) A "bargain sale" is a sale of an asset to a charity for less than its full fair market value, which can result in a partial deduction. A bargain sale of appreciated assets will also result in some taxable gain.

(e) The cash value of life insurance contributed to a charity and premium payments on a charity-owned policy can be deductible if certain requirements are met. The charity must be irrevocably designated as the beneficiary, and the donor cannot retain any control or benefit from the policy.

1.5 Partial Interests. Generally, a charitable deduction is not available unless the donor gives away his or her full interest in the property given. This is why there is no deduction for allowing a charity to use an asset. Some of the exceptions for charitable trust interests and nontrust interests are discussed below.

2. GIFTS OF NON-TRUST PARTIAL INTERESTS

2.1 Remainder Interest in Personal Residence or Farm. A donor may convey to a qualified charity a remainder interest in a personal residence or farm. In other words, the donor may retain an interest for life ("life estate") and receive a charitable deduction for the remainder interest. The value of the remainder interest is determined by reference to the IRS valuation tables and the donor's age.

2.2 Pooled Income Funds. A charitable deduction is available for contributions to a "pooled income fund" where the donor retains a lifetime income benefit. The trust must be maintained by the charity, and the donor is not allowed to serve as Trustee or to retain any other control.

2.3 Other Partial Interests. If the donor only owns a partial interest (such as a life estate or remainder interest), a charitable deduction for the gift of that interest—or even an undivided portion of that interest— is allowed. If the donor gives an income interest to one charity and a remainder interest to another without retaining any interest, the charitable deduction is allowed.

3. CHARITABLE REMAINDER TRUSTS

3.1 Basic Provisions: A charitable remainder trust allows one or more individuals ("noncharitable beneficiaries") to receive designated annual payments during their lifetime or during a set term of years (up to 20 years).

(a) The annual payments are usually stated in terms of a percentage (e.g., 8%) of the value of the trust's assets, but they can be stated in terms of a specific dollar amount if the amount is at least 5% of the value of the trust's assets. Upon the death of the noncharitable beneficiary or beneficiaries or upon the expiration of the specified term, the remainder of the trust passes to one or more charitable organizations.

(b) Charitable trusts require charitable intent. Even if that is not the primary motivation for establishing the trust, one or more charitable organizations must be the intended recipients of some benefit from the trust. If the trust is structured so that no benefit will pass

to charity, the charitable deduction will be denied, and it is possible that the trust can be disqualified as a tax-exempt entity.

(c) Grantors of charitable trusts can be the noncharitable beneficiaries. If the trust is established during the grantors' lifetime, the grantors are entitled to a charitable deduction for the present value of the remainder interest, which is calculated according to the IRS tables based on the grantors' life expectancies or the term of the trust, current interest rates, and the rate used to calculate annual payments for the life or term beneficiaries.

(d) There are two types of charitable remainder trusts: charitable remainder annuity trusts (CRAT's) and charitable remainder unitrusts (CRUT's). CRAT's provide for fixed payments despite asset valuation fluctuations, and CRUT's allow for payments that can increase with inflation and provide flexibility for the timing of trust payments.

(e) Charitable remainder trusts are tax exempt, so the trust itself does not pay any income taxes, even as to retained income. The life or term beneficiary is taxed on income distributed to the beneficiary.

3.2 **Variations of the Charitable Remainder Trust:** A charitable remainder trust ("CRT") can be structured in several ways, providing planning opportunities to meet different needs and objectives.

(a) Mandatory Payments. Sometimes we refer to the annuity or unitrust distributions as "income" distributions, but sometimes those distributions actually include trust principal. If a CRAT or CRUT provides for mandatory annuity or "unitrust" payments and trust income is insufficient, the principal must be used. This mandatory for a charitable remainder annuity trust ("CRAT"), but it is only one option for a charitable remainder unitrust ("CRUT").

(b) NIMCRUT. Because many CRTs are given illiquid and even hard-to-sell assets, it is often not practical to make distributions of trust principal. For example, trust funded with stock in a closely-held corporation would quickly be dissipated if distributions of stock had to be made, particularly when valuation discounts are applied to the distributions. The law permits a CRUT to provide for the payment of the annual unitrust amount or net income, whichever is less. Any portion of the unitrust amount is a deficiency that accumulates. In any year in which the net income exceeds the unitrust amount, the trustee can pay out the income to the extent of the cumulative deficiency. This type of CRUT is called a "NIMCRUT", which is a CRUT with a "net income" limitation with a "makeup" provision.

(c) Income "Spigot". The income payable from a NIMCRUT can be manipulated to some degree by the investments that are made.

(1) If the grantor or other income beneficiary does not require distributions for a period of time, investments can focus on capital growth. When income distributions are desired, the investments can shift to assets that produce higher income.

(2) To control the income flow even further, the CRUT can put its investments in a limited-liability company ("LLC") or a limited partnership ("LP"). If the trust provides that "distributable income" or "accounting income" does not include any income not actually distributed to the trustee, the income reported by the LLC or LP does not trigger a distribution to the income beneficiary from the CRUT.[4] This allows investments to accumulate until such time as distributions are desired. If the trust's definition of distributable income includes capital gain, capital growth can be included in distributions when distributions from the LLC or LP are actually made to the CRUT.

3.3 **Reasons to Create a Charitable Remainder Trust:** There are as many reasons to created a charitable remainder trust ("CRT") as there are people who create them. Some of the most common reasons include the following:

(a) Charitable Intent. The grantor of the trust wants to benefit charity (i.e., one or more charitable organizations). If the grantor does not feel that the amount contributed to the trust needs to pass to his children or other beneficiaries, no further planning is necessary. If the grantor wants to replace the gifted assets, a life insurance trust is appropriate. [See subsection 3.4 on page 6.]

(b) Reduction of Capital Gain. Highly appreciated assets are often contributed to charitable trusts in order to eliminate potential capital gains tax that will become due when the asset it sold. This can be an "income maximizer trust". For example, rental properties having a current fair market value of $1,000,000 and a cost basis of $0 are contributed to a charitable trust. When the properties are subsequently sold, the capital gain tax of some $150,000 has been avoided inside the charitable trust, leaving more proceeds available to generate the income necessary to pay the life or term beneficiary.

(c) Diversification. Some people have significant investments in a single company. This is particularly true for one of the original founders of a company that has gone public. By contributing undiversified assets into a charitable remainder trust, the portfolio can be partially liquidated and reinvested in a more diverse portfolio. Because a CRT is a tax-exempt entity, the sale of the appreciated property does not trigger capital gain.

(d) Retirement Planning. Charitable remainder unitrusts can serve as a quasi retirement plan. A trustee can defer some of the annual payments in the early years of the trust by investing in high-growth, low-income assets. When the life beneficiary has a greater need for income, the trustee can invest in assets producing a higher income yield. The combination of a NIMCRUT with an LLC or LP is even better at deferring income, allowing a working

[4] Normally, partnership income is deemed to be income to any partner, whether or not actually distributed. The partnership (which can include a limited partnership or a limited-liability company) provides a form K-1 showing the partner's income that must be reported on the partner's tax return, whether or not received. Taxable income that is not actually received is often called "phantom income". Because the CRUT is a tax-exempt income, K-1 income does not trigger any tax. By defining "distributable income" or "accounting income" to exclude phantom income, no CRUT distributions are required until actual distributions from the LP or LLC are made.

grantor to accumulate "retirement" funds. Once the grantor retires, the LLC or LP can distribute assets (or be dissolved), allowing the CRUT to have distributable income. To protect against a premature death, this plan is combined with a life insurance held in an irrevocable trust ("wealth replacement trust"), as discussed in subsection 3.4 of this memo.

3.4 **"Income Maximizer Trust" and the "Wealth Replacement Trust":** A charitable trust can be an "income maximizer trust", but the trust's assets eventually pass to one or more charities, and there is nothing that passes to children or other noncharitable beneficiaries. For many people, the wealth that passes to one or more charities can be replaced with life insurance, which can be purchased with the savings that result from the income tax deduction and from the additional income that results from a tax-free sale of appreciated assets inside the trust. If the insurance is purchased by the trustee of an irrevocable life insurance trust, the insurance proceeds are not taxable for estate tax purposes. The insurance trust becomes a "wealth replacement trust", allowing the children or other beneficiaries to receive benefits after all.[5]

4. CHARITABLE LEAD TRUSTS

4.1 **Overview:** In large estates, the estate tax[6] can result in the liquidation of hard-to-sell assets (such as family businesses), often resulting in "fire-sale" prices, which reduce even further the net distribution to the family or other beneficiaries. Estate liquidation can result in losses that make the estate tax seem higher than it really is.

(a) A charitable lead trust is a trust for a term of years, and during the trust term a specified annual payment (based on a percentage of the value of trust assets) is paid to one or more designated charitable organizations. Children or other beneficiaries are designated as the remainder beneficiaries who will receive the trust assets at the end of the trust's term.

(b) The creation of a charitable lead trust results in a gift to the noncharitable remainder beneficiaries based on the present value of the remainder interest. That value — which is determined from the IRS tables — depends on the term of the trust and the rate or amount of the specified payment going to the charitable organization(s). It is possible to design a charitable lead trust so that the remainder interest has little or no value for gift or estate tax purposes.

(c) Although the specified payments are made to one or more charities during the trust's term, the asset itself is preserved for the children. While the children may have to wait 5, 10, 15, or even 20 years in order to benefit from the trust's assets, it is often the best way to pass some assets to the children without the combined effects of estate taxes and asset liqui-

[5]This technique is more fully discussed in a separate memo entitled "USING A CHARITABLE TRUST AND AN IRREVOCABLE LIFE INSURANCE TRUST".

[6]The maximum rate imposed for federal estate tax purposes was, is, and will be: 50% in 2002; 49% in 2003; 48% in 2004; 47% in 2005; 46% in 2006; 45% in 2007, 2008, and 2009; 0% in 2010; and 55% in 2011 and beyond.

dation costs. The longer they wait, the lower the value of the remainder interest is for gift tax purposes.[7]

5. CREATING YOUR OWN CHARITY

5.1 Generally: If you have decided to leave a legacy to one or more charitable organizations, perhaps you may want to consider forming your own charitable organization. Many of those people form a trust or nonprofit corporation, either during life or at death under their will or living trust, that is established for charitable purposes.

5.2 Public Charity. If the charitable organization to be formed will be substantially supported by the general public, by other charitable organizations, or by governmental agencies, it is possible to qualify the organization as a public charity that will qualify as a 50% charity. A public charity is considered better than a private foundation because it is not subject to many of the restrictive rules that apply to a private foundation, such as the rules against engaging in self-dealing, having excess business holdings, or receiving unrelated business taxable income. The IRS must approve the public charity status of the organization, but the organization can be allowed up to five years to qualify under the public support requirements. The costs to maintain a public charity and comply with all requirements can be significant, so it is rarely the recommended choice of charitable organizations unless significant contributions are anticipated.

5.3 Private Foundations: A "private foundation" can be established as a nonprofit corporation or as a trust. It can be established for almost any charitable purpose.

(a) The main benefit of a private foundation over a public charity is that the founder retains control. The trustees or officers of the foundation may receive "reasonable compensation" for their services, and, for foundations with significant assets and income, those directing the foundation's investments and disbursements can be influential in the community because of their control over the foundation.

(b) There are, however, several drawbacks to a private foundation, including:

(1) A private foundation is a "30% charity", thus limiting the deductibility of contributions to a private foundation, as discussed in paragraph 1.2(b), above.

(2) The investment income of a private foundation is subject to a 1% or 2% excise tax.[8]

[7] Unfortunately, charitable lead trusts do not make good generation-skipping trusts because the GST exemption is applied when the charitable interest expires. For this reason, grandchildren may not be the ideal beneficiaries for charitable lead trusts.

[8] IRC § 4940.

(3) A private foundation cannot have business income that is known as "unrelated business taxable income"[9] or "UBTI". Even one penny of UBTI can cause the foundation to lose its tax-exempt status.[10]

(4) The founder of a private foundation, together with members of the founder's family, are "disqualified persons", who are prohibited from engaging in any "self-dealing" transactions with the foundation.[11]

(5) A private foundation is prohibited from having "excess business holdings", the calculation of which takes into account the holdings of the founder and other substantial contributors and their relatives.[12]

(6) A foundation is required to distribute 5% of its assets annually to qualified entities, such as public charities.[13]

5.4 Supporting Organization. A "supporting organization" is, in essence, a hybrid between the private foundation and the donor-advised fund. The supporting organization is affiliated with a public charity, most often a community foundation, but it operates as a separate entity.

(a) A supporting organization is preferred by those who want a role that is beyond that of a donor-advisor but who want avoid the disadvantages of a private foundation (as outlined in paragraph 5.3(b), above).

(b) There are three types of supporting organizations[14], but the affiliated charity may or may not allow all three types.

(1) Type I requires the supported public charity to control the supporting organization, and is most akin to the donor-advised fund.

(2) Type II requires joint control of the supported public charity and the supporting organization.

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[9]IRC § 512(a).

[10]IRC § 664(c).

[11]IRC § 4941 ; Regs. § 53.4941(d)-1 through 53.4941(d)-4 .

[12]IRC § 4943.

[13]IRC § 4942.

[14]See IRC § 509(a)(1) and 509(a)(2) and related regulations.

(3) Type III requires that the supporting organization be "responsive to" and play an "integral part" in the operations of the supported public charity, and the regulations define those requirements in some detail.[15]

5.5 Donor-Advised Fund. Some investment advisors and community foundations have established public charities that allow contributions to be segregated into separate funds are invested and distributed by the public charity with the advice of the donor. The donor's advice is not binding, but unless the donor's advice is unreasonable, it is commonly followed. The advantages of a donor advised fund include:

(a) Lower set-up costs and administrative costs; and

(b) The absence of the drawbacks to the private foundation (as outlined in paragraph 5.3(b)).

5.6 Conclusion. You may form a public charity, a supporting organization to a public charity, or a private foundation. You will incur both setup and maintenance expenses for each of those organizations. If none of those choices is practical after balancing your objectives and the related expenses, then making donations or leaving a legacy to a donor-advised fund sponsored by an existing charity (such as a community foundation, university, or broker-sponsored charity) may accomplish your objectives without really creating a charitable organization of your own. If your objectives are satisfied by the programs and policies of one or more existing charities, then a gift or bequest directly to the charity or charities is the simplest solution of all.

6. GIFTS AT DEATH.

6.1 Gifts under A Will or Trust. Transfers to qualified charities upon death under a will or trust will not qualify for an income tax deduction, but will qualify for the unlimited charitable deduction for estate tax purposes. Gifts at death can be made to a charitable remainder trust or to one's own charity.

(a) If the will or trust creates a charitable remainder lead trust or a charitable remainder unitrust, the estate tax charitable deduction will only be for the value of the charity's interest, which means that an estate tax will be due to the extent the noncharitable interest is not covered by the applicable exclusion for estate tax purposes. The calculation of the deduction depends on the applicable federal rate of interest at the time, the life beneficiary's age or the term of years specified, and the IRS valuation tables provided by regulation.

(b) A private foundation that does not already exist can actually be established under the terms of a will or trust. The law provides deadlines that must be met in order to qualify for the charitable deduction for estate tax purposes.

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[15] Reg. § 1.509(a)-4(i)(2) and 1.509(a)-4(i)(3).

6.2 Life Insurance. The proceeds of life insurance payable to one or more qualified charities is also deductible for estate tax purposes.

6.3 Limitations. A gift to a charity does not qualify for a charitable deduction if it is not mandated under the will, trust, or other dispositive instrument *and* the amount is readily ascertainable. For example, if the executor of a will has the discretionary power to make distributions, a charitable deduction is not available if that power could have been exercised in favor of a nonqualified person or entity.

7. CONCLUSION

7.1 **Goals:** Estate planning has competing goals. For example, saving transfer taxes on your assets will often reduce your lifetime control and benefit over those assets. The best estate plan for you is one that balances your objectives according to your own priorities. It is up to you how hard you want to play the tax-planning game. In other words, if saving taxes frustrates other estate-planning objectives, you must decide which objectives take priority.

7.2 **Advanced Estate Planning Tools:** The basic estate plan begins with a will or revocable trust. This memo has discussed charitable giving techniques that go beyond the basics and are typically used only by those who have potential estate tax problems that cannot be resolved with revocable trusts and irrevocable life insurance trusts.

7.3 **Costs:** Each estate planning "tool" has its price. Before utilizing a tool, you must be committed to paying all of the costs.

(a) Legal fees, accountants' fees, and other expenses are part of the cost of establishing and maintaining trusts and business entities.

(b) The most sophisticated estate planning techniques often require expert appraisers who can determine valuation discounts for transfer-tax purposes.

(c) "If it's not worth doing right, it's not worth doing." It may be tempting to cut costs by: hiring inexperienced appraisers; refusing to employ qualified tax accountants; avoiding the use of corporate trustees; purchasing cheap insurance products; and even trying do-it-yourself documents for business and trusts. This is a false economy for most estate planning, especially where federal transfer-taxes are involved. For example, with respect to a million-dollar charitable remainder unitrust, a qualified appraisal can save you problems with the IRS on an income tax audit if the IRS subsequently challenges the value of the contributed property. Since the deduction can be significant, it is foolish not to properly document it.

7.4 **Going Forward:** This memo is necessarily oversimplified, and it does not contain all the technical rules that apply in the area of charitable giving. Because of this, some of the general rules explained here may have exceptions or restrictions that have not been explained. Many of the technical rules depend on factors that are unique to each individual or couple. In order to determine some of the planning techniques that may be appropriate for you, it is important to have a complete picture of your estate and your resources, including income sources, a description of your assets

(including the current value and the cost basis for each asset). It is advisable for you to build an estate planning team that can coordinate their efforts for your benefit. The team may include your accountant, your insurance advisor, your investment advisor, and business advisors (in addition to your estate-planning attorney, of course). Once the facts are known and your planning team is in place, we can work together to analyze your estate planning options and to make recommendations.

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The Rushforth Firm, Ltd.

A Nevada Professional Limited-Liability Company

Receptionist: 702.255.4552 or 866.740.9195
Fax: 702.255.4677 or 866.740.9197
E-mail: office@rushforth.net
rushforth.net | rushforthfirm.com
PO Box 371655
Las Vegas, NV 89137-1655