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Charitable Giving

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Charitable Giving

When developing your estate plan, you can do well by doing good. Leaving money to charity rewards you in many ways. It gives you a sense of personal satisfaction, and it can save you money in estate taxes.

A few words about estate taxes

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act), gradually eliminates federal estate taxes by increasing the amount that is exempt from these taxes over several years (from $1 million in 2002 and 2003 to $3.5 million in 2009); reducing the top rate over several years (50 percent in 2002, 49 percent in 2003, 48 percent in 2004, 47 percent in 2005, 46 percent in 2006, and 45 percent in 2007 through 2009); and finally repealing estate taxes for persons who die after 2009. However, under a provision in the law, pre-2001 Tax Act rules will return after 2010.

Whether you are subject to federal estate taxes depends on the size of your estate and the year you die. Tax law changes only increase the need for careful planning, and charitable giving can play an important role in many estate plans. By leaving money to charity when you die, the full amount of your charitable gift may be deducted from the value of your taxable estate.

Make an outright bequest in your will

The easiest and most direct way to make a charitable gift is by an outright bequest of cash in your will. Making an outright bequest requires only a short paragraph in your will that names the charitable beneficiary and states the amount of your gift. The outright bequest is especially appropriate when the amount of your gift is relatively small, or when you want the funds to go to the charity without strings attached.

> ***By leaving money to charity when you die, the full amount of your charitable gift may be deducted from the value of your taxable estate.***

Make a charity the beneficiary of an IRA or retirement plan

If you have funds in an IRA or employer-sponsored retirement plan, you can name your favorite charity as a beneficiary. Naming a charity as beneficiary can provide double tax savings. First, the charitable gift will be deductible for estate tax purposes. Second, the charity will not have to pay any income tax on the funds it receives. This double benefit can save combined taxes that otherwise could eat up a substantial portion of your retirement account.

Use a charitable trust

Another way for you to make charitable gifts is to create a charitable trust. There are many types of charitable trusts, the most common of which include the charitable lead trust and the charitable remainder trust.

A charitable lead trust pays income to your chosen charity for a certain period of years after your death. Once that period is up, the trust principal passes to your family members or other heirs. The trust is known as a charitable lead trust because the charity gets the first, or lead, interest.

A charitable remainder trust is the mirror image of the charitable lead trust. Trust income is payable to your family members or other heirs for a period of years after your death or for the lifetime of one or more beneficiaries. Then, the principal goes to your favorite charity. The trust is known as a charitable remainder trust because the charity gets the remainder interest. Depending on which type of trust you use, the dollar value of the lead (income) interest or the remainder interest produces the estate tax charitable deduction.

Why use a charitable lead trust?

The charitable lead trust is an excellent estate planning vehicle if you are optimistic about the future performance of the investments in the trust. If created properly, a charitable lead trust allows you to keep an asset in the family while being an effective tax-minimization device.

For example, you create a $1 million charitable lead trust. The trust provides for fixed annual payments of $80,000 (or 8 percent of the initial $1 million value of the trust) to ABC Charity for 25 years. At the end of the 25-year period, the entire trust principal goes outright to your beneficiaries. To figure the amount of the charitable deduction, you have to value the 25-year income interest going to ABC Charity. To do this, you use IRS tables. Based on these tables, the value of the income interest can be high--for example, $900,000. This means that your estate gets a $900,000 charitable deduction when you die, and only $100,000 of the $1 million gift is subject to estate tax.

Why use a charitable remainder trust?

A charitable remainder trust takes advantage of the fact that lifetime charitable giving generally results in tax savings when compared to testamentary charitable giving. A donation to a charitable remainder trust has the same estate tax effect as a bequest because, at your death, the donated asset has been removed from your estate. Be aware, however, that a portion of the donation is brought back into your estate through the charitable income tax deduction.

Also, a charitable remainder trust can be beneficial because it provides your family members with a stream of current income--a desirable feature if your family members won't have enough income from other sources.

For example, you create a $1 million charitable remainder trust. The trust provides that a fixed annual payment be paid to your beneficiaries for a period not to exceed 20 years. At the end of that period, the entire trust principal goes outright to ABC Charity. To figure the amount of the charitable deduction, you have to value the remainder interest going to ABC Charity, using IRS tables. This is a complicated numbers game. Trial computations are needed to see what combination of the annual payment amount and the duration of annual payments will produce the desired charitable deduction and income stream to the family.

Charitable Lead Trust

Definition

A charitable lead trust is a trust with both charitable and noncharitable beneficiaries. It is called a lead trust because it is the charity that is entitled to the lead interest in the trust property. After a specified term, the remaining trust property passes to you or another noncharitable beneficiary you designate.

Prerequisites

- A desire to donate to charity
- A substantial asset to donate to charity

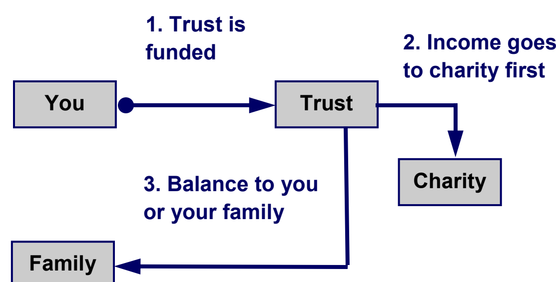
Key strengths

- Provides a gift and estate tax haven for assets expected to appreciate in value
- Allows you to donate to charity and keep trust assets within the family
- Allows you to postpone the noncharitable beneficiary's receipt of the trust assets
- Allows you to choose the payment method to charity
- Does not require any minimum percentage payout to charity
- Reduces potential federal estate tax liability

Key tradeoffs

- No income tax deduction unless you are also the "owner" of the charitable lead trust
- Requires an irrevocable commitment
- Requires the charitable payment to be made each year, regardless of whether there is sufficient trust income available

How a Charitable Lead Trust Works



Variations from state to state

- Community property states may affect any gift tax due
- In certain instances (when the trust document is silent), state law may determine the source of payments made from the trust to charity and the order they are to be used

How is it implemented?

- Consult a legal professional to draft the charitable lead trust document
- Select a noncharitable beneficiary, a charitable beneficiary, and a trustee
- Select the assets you want to use to fund the charitable lead trust
- Select an appraiser or other professional to value unmarketable assets
- Select the term of the trust and the payment method (annuity or unitrust)

Charitable Remainder Trusts

Charitable remainder annuity trust (CRAT)

A charitable remainder annuity trust, or CRAT, is a trust with both charitable and noncharitable beneficiaries. Every year for the term of the CRAT, the noncharitable beneficiary receives a payment (the annuity amount) from the trust property. At the end of the trust term, the remaining property passes to the charity. For this reason, the charity's interest is described as a remainder interest.

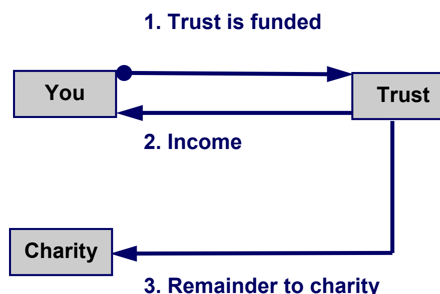
Unique strengths	Unique tradeoffs
Pays out fixed income every year	Requires the annuity to be paid each year, regardless of whether there is sufficient trust income available
Exists with fairly simple administration	Inflation may cause CRAT to lose some of its value
	Prohibits the additional contribution of assets

Charitable remainder unitrust (CRUT)

A charitable remainder unitrust, or CRUT, is a trust with both charitable and noncharitable beneficiaries. Every year for the term of the CRUT, the noncharitable beneficiary receives a payment (the unitrust amount) from the trust property, which is based on the value of the trust assets each year. At the end of the trust term, the remaining property passes to the charity. For this reason, the charity's interest is described as a remainder interest.

Unique strengths	Unique tradeoffs
Allows for the additional contribution of assets	Involves more complicated administration
Allows annual payment to increase when value of trust property increases	Annual payment may decrease when value of trust property decreases

Common elements of charitable remainder trusts



Prerequisites

- A desire to donate to charity
- A substantial asset to donate to charity

Key strengths

- Provides income tax deduction
- Provides an income tax haven for assets that have appreciated substantially
- Reduces potential federal estate tax liability

Key tradeoffs

- Requires an irrevocable commitment

Variations from state to state

- Community property states may affect any gift tax due

How are they implemented?

- Consult a legal professional to draft the trust
- Select a noncharitable beneficiary, a charitable beneficiary, and a trustee
- Select the assets you want to use to fund the trust
- Set the term of the trust and establish the annual payment amount for CRATs or the percentage of trust assets that are to be paid out every year for CRUTs
- Select an appraiser to value unmarketable assets

The Best Property to Give to Charity

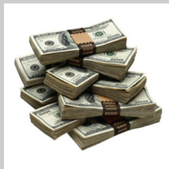
Giving to charity is not only personally satisfying, the IRS (and possibly your state) also rewards you with generous tax breaks.

- Current income tax deduction if you itemize, subject to certain percentage limitations for any one year
- Tax benefit received reduces the cost of the donation (e.g., a $100 donation from someone in a 30 percent tax bracket has a net cost of $70)
- Reduces or eliminates capital gains tax if appreciated property is given
- No transfer (gift and estate) taxes imposed
- Removes any future appreciation of the donated property from your taxable estate

Highly appreciated or rapidly appreciating property*

Such as:

- Intangible personal and real property (e.g., stock or real estate)
- Tangible personal property (e.g., art, jewelry)



Cash

- Easy to give--the type of donation most charities like best
- Be sure to get a receipt or keep a bank record, regardless of the amount

Income-producing property*

Such as:

- Artwork (if given by the artist)
- Inventory
- Section 306 stock (stock acquired in a nontaxable corporate transaction)

Tangible personal property*

Such as:

- Cars
- Jewelry
- Paintings

Remainder interests in property

- Lets you use the property, or income from the property, until a later date. Gift and estate tax deductions are not allowed unless a trust is used. You may only take the income tax deduction in the year that the gift is actually conveyed.

* You may need to have certain types of property appraised.

Life Insurance and Charitable Giving

Life insurance can be an excellent tool for charitable giving. Not only does life insurance allow you to make a substantial gift to charity at relatively little cost to you, but you may also benefit from tax rules that apply to gifts of life insurance.

Why use life insurance for charitable giving?

Life insurance allows you to make a much larger gift to charity than you might otherwise be able to afford. Although the cost to you (your premiums) is relatively small, the amount the charity will receive (the death benefit) can be quite substantial. As long as you continue to pay the premiums on the life insurance policy, the charity is guaranteed to receive the proceeds of the policy when you die. (Guarantees are subject to the claims-paying ability of the issuing insurance company.) Since life insurance proceeds paid to a charity are not subject to income and estate taxes, probate costs, and other expenses, the charity can count on receiving 100 percent of your gift.

Giving life insurance to charity also has certain income tax benefits. Depending on how you structure your gift, you may be able to take an income tax deduction equal to your basis in the policy or its fair market value (FMV), and you may be able to deduct the premiums you pay for the policy on your annual income tax return. When an insurance contract is transferred to a charity, the donor's income tax charitable deduction is based on the lesser of FMV or adjusted cost basis.

What are the disadvantages of using life insurance for charitable giving?

Donating a life insurance policy to charity (or naming the charity as beneficiary on the policy) means that you have less wealth to distribute among your heirs when you die. This may discourage you from making gifts to charity. However, this problem is relatively simple to solve. Buy another life insurance policy that will benefit your heirs instead of a charity.

> ***Life insurance can be an excellent tool for charitable giving.***

Ways to give life insurance to charity

The simplest way to use life insurance to give to a charity is to name a charity to receive the benefits of your life insurance policy. You, as owner of the policy, simply designate the charity as beneficiary. Designating the charity as beneficiary may allow you to make a larger gift than you could otherwise afford. If the policy is a form of cash value life insurance, you still have access to the cash value of the policy during your lifetime. However, this type of charitable gift does not provide many of the income tax benefits of charitable giving, because you retain control of the policy during your life. When you die, the proceeds are included in your gross estate, although the full amount of the proceeds payable to the charity can be deducted from your gross estate.

Another alternative is to donate an existing life insurance policy to charity. To do this, you must assign all rights in the policy to the charity. You must also deliver the policy itself to the charity. By doing this, you give up all control of the life insurance policy forever. This strategy provides the full tax advantages of charitable giving because the transfer of ownership is irrevocable. You may be able to take an income tax deduction equal to the lesser of your adjusted cost basis or FMV. The policy is not included in your gross estate when you die, unless you die within three years of the transfer. In this case, your estate would get an offsetting charitable deduction.

A creative way to use life insurance to donate to a charity is simply for the charity to insure you. To use this strategy, you would allow the charity to purchase an insurance policy on your life. You would make annual tax-deductible gifts to the charity in an amount equal to the premium, and the charity would pay the premium to the insurance company.

One final method is to use a life insurance policy in conjunction with a charitable remainder trust. This strategy is relatively complex (it will require an attorney to set up), but it provides greater advantages than other, simpler methods. You set up a charitable remainder trust and transfer ownership of other, income-producing assets to the trust. The income beneficiary of the trust (you or whomever you designate) will get the income from the assets in the trust. At the end of the trust term (which might be a certain number of years or upon the occurrence of a certain event, such as your death), the property in the trust would pass to the charity. You'll receive a current tax deduction when you establish the trust for the FMV of the gifted assets, reduced according to a formula determined by the IRS. Life insurance can then be purchased (usually inside an irrevocable life insurance trust to keep the proceeds out of your estate) to replace the assets that went to the charity instead of to your heirs.

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