ADVENTURES IN CHARITABLE GIVING

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> "These Americans are the most peculiar people in the world. ... In a local community, in their country a citizen may conceive of some need, which is not being met. What does he do? He goes across the street and discussed it with his neighbor. Then what happens? A committee comes into existence and then the committee begins functioning on behalf of that need. ... All of this is done by private citizens on their own initiative."
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> -Alexis de Tocqueville, *Democracy in America* (1835)

The combination of ingenious uses of the split-interest gift, with the tax incentives to make charitable gifts, can induce our clients to confer a powerful benefit. Great wealth is not required. Just the spark of wanting to somehow improve the world. Ordinary people can be philanthropists, if an advisor can just recognize and show them the tools that are readily available. You and I can be that advisor. We all benefit from charity--often in ways we do not see.

In creating these materials, I gratefully acknowledge the practical assistance of Kristin McGinnis, MBA, *Kristin.McGinnis@auctoris.com*, 303/531-2235 and Caroline (Lina) Stein, Esq., *Caroline.Stein@colorado.edu*, 303/735-6942, the comments of Frank T. Hill, Esq. and L. William Schmidt, Esq., and production help from CBA-CLE staff and Lisa Battista and Patrick Maclean of my office.

PART 1: CHARITABLE GIFTS THAT PRODUCE INCOME

GENERAL CHARACTERISTICS

TAX BENEFITS

Congress extends generous rewards to encourage charitable giving by individuals. IRC § 664. Generally speaking, the four economic and tax rewards for charitable gifts that produce income are:

< An income stream for life or for a term of years not to exceed twenty. Depending on the vehicle, the lives could be joint (concurrently or consecutively), and the income stream delayed until later.

< A charitable income tax deduction based on the current value of the property or cash donated. While there is a limitation on the amount of this deduction that can be applied against the donor's Adjusted Gross Income (AGI) each year, unused deduction can be applied in up to five future years until it is consumed. The result is lower income taxes--and thus more spendable income--for the donor for a period of up to six years (1 + 5).

< A deferral and diminution of long term capital gain income tax when the asset donated is appreciated, such as securities or land. It is incorrect to say that capital gain income tax is avoided, but the amount of gift is the current value of the assets donated (regardless of gain) and income at capital gain rates is one of four components of the income stream to the donor. (See Four-Tier Payout discussion, below.) The donor also benefits from having the gift reinvested in a tax-free vehicle over time. In most cases, the donor client benefits from increased income from the full proceeds of sale of the appreciated assets, not the net amount remaining after capital gain taxes are paid--perhaps in addition to the decreased income tax burden from the charitable income tax deduction.

< Because the gift and its appreciation are not in the donor's estate at death, there is a reduction in the costs of estate administration (such as real estate) and a possible reduction in the amount of federal estate tax if the donor has a taxable estate.

Depending on the client's age, situation and the amount the client is willing to give, these benefits can be tailored to a degree. For instance, long-term income or relief from income taxes can be emphasized. Bigger gifts yield more options and larger rewards, but the same four benefits exist for all such gifts, even relatively small ones.

Generally, the older the client, the lower the payout rate, or both, the higher the income tax deduction because the odds are higher the charity will receive more in the end. Conversely, the younger the client, the higher the payout rate, or the longer the payout period, the lower the income tax deduction because the odds are higher the charity will receive less in the end.

GENERAL CHARACTERISTICS

NON-TAX BENEFITS OF PLANNED CHARITABLE GIVING

Planned gifts are not gifts made to charity throughout life, but most often are gifts of accumulated wealth. Among the more common non-tax reasons for planned giving:

- The "warm glow" that comes from helping others. This idea is sometimes expressed as fulfilling a client's philanthropic intent.

- Create a legacy to either maintain something the client views as worthwhile, or build or grow change in the world that the client views as worthwhile.

- Keep an estate or devises for children or grandchildren below a desired amount. Clients with larger estates may not want to create generations of silver-spoon children or grandchildren. If they don't want their descendants to receive "too much," the "excess" can pass to charity.

- Re-align a client's investment portfolio. Cull the "dogs" that are under-performing, of low basis (with perhaps high appreciation)--or both--all in a tax-favored manner.

- Turn non-income-producing assets into a reliable income stream. Clients can liquidate an appreciated asset and reposition all the proceeds without being reduced by capital gains tax because the charity or trust is exempt from income tax.

- So called "Designer Philanthropy": advance desired causes in a more direct, hands-on manner. This could also be a desire to support more-efficient "private sector" charity v. inefficient "public sector" (tax-supported) charity.

- Demonstrate or educate younger generations on the societal benefit of philanthropy.

GENERAL CHARACTERISTICS

DISADVANTAGES OF INTER VIVOS GIFTS

There are "costs" to charitable giving in terms of advisor and transaction costs, possible lost opportunities, and depending on the tool used and variables selected not all of a gift will likely be deductible. There are also two bigger risks--of which clients should be informed in writing. The first is that the governing instrument, and all gifts made under it, are irrevocable. The client or the client's family cannot get the asset back or use it as collateral. Clients should also be aware that assets contributed are often promptly sold, but the proceeds are then reinvested.

The second major risk is that the donor dies prematurely, before she or he can receive the full measure of rewards for charitable giving. Therefore, though the economic benefits of planned giving can be very attractive in the right circumstances, clients should be cautioned against "putting all your eggs in one basket."

GIFTS THAT PRODUCE INCOME

CHARITABLE GIFT ANNUITY (CGA) AND DEFERRED GIFT ANNUITY

Charitable Gift Annuity. The charitable gift annuity is among the oldest and most popular planned gifts. Donors give cash or assets to a charity in exchange for a contractual promise to pay a fixed amount each year for the lifetime of one or two annuitants.

The payout interest rates for most charities will be within a range set (and periodically updated) by the nonprofit American Council on Gift Annuities (ACGA). Recent ACGA charts for one and two-life payout rates by age are in the appendix. Larger charities will back the contractual payouts themselves. Because of the risk, smaller charities will purchase a commercial annuity contract from a life insurance company.

It will vary among charities, but many will offer CGAs for as little as $10,000 (with $20,000 or $25,000 more common) up to as much as $1 Million dollars. The gift agreement and all disclosures are relatively simple, often just a few pages. The gift, the payout rate and frequency of payments, and the identity of the annuitant(s) are all fixed as of the date of the contract and cannot be changed.

CGAs are favored by "older" donors, or those who will make more modest gifts.

Deferred Annuity. If the date of the first annuity payment is delayed it is a deferred annuity, and the overall payout may be somewhat higher because of the deferral. Some charities will allow a series of gifts until the time the first payment is to be made.

A deferred gift annuity is a good vehicle for "younger" donors, say, in the 45-65 age range. The economic advantages: Generates income tax deductions in the year of the gift(s), perhaps during peak earning years; income is deferred to years when the donor needs it, when it may be taxed at lower income tax rates; supplements a donor's other sources of retirement income; if the annuity is funded with appreciated assets the capital gain taxes are minimized because the capital gain is not reportable until the year the payments begin, and then the gain is spread over the actuarial life expectancy of the donor.

GIFTS THAT PRODUCE INCOME

CHARITABLE REMAINDER ANNUITY TRUST (CRAT)

The qualified charitable remainder annuity trust provides a fixed dollar amount of income annually, based on a percentage of the initial fair market value of the assets gifted to the trust. The payout rate must be at least 5%, payable each year. The term of the CRAT can be for one or more lifetimes (such as a married couple), a term of years not to exceed 20, or a combination of lifetimes and years. Additional gifts *cannot* be made to a CRAT after its creation.

For non-cash gifts, the trustee will usually sell the donated property tax-free, and invest the proceeds into a diversified portfolio appropriate to the income beneficiary(ies) and time horizon (term) of the trust. Note that a charitable income tax deduction will be denied by the IRS if the CRAT fails certain probability and percentage tests intended to prevent aggressive abuses that benefit the donor. A donor should have at least $100,000 of assets or cash to give. It will vary among charities but according to some development officers, to justify the cost a donor should have at least $400,000 of assets or cash to give to a CRAT if the charity will be trustee, and at least $500,000 if a corporate fiduciary will be the trustee.

CRATs can be trusteed by corporate or professional trustees, or by the charitable remainderman itself in the case of larger charities. Because of the many particular IRS requirements of the initial gift and of ongoing trust management, in order to avoid self-dealing and maintain tax-exempt status, donor-clients should be strongly discouraged from being their own trustees.

If the CRAT earns less than the stated annual payment the trustee must invade principal to meet the required payment. If the trust earns more than the stated annual payment the excess income is added to principal.

While the remainder beneficiary of a qualified charitable remainder trust must be a true "§170(c)," charitable organization, note that in some cases the donor may reserve the right to change the charitable remainder beneficiary(ies).

Four-Tier Payout. Income from a charitable remainder trust is income-taxable to the beneficiaries. The trustee must pay income in the following order:

1) Ordinary "net income" (interest and dividends). Also, any undistributed ordinary income from prior years. This is reported as ordinary income to the beneficiary.

2) Capital gain income--short-term first, then long-term. Also, any undistributed capital gain income from prior years. This is reported as capital gain income to the beneficiary.

3) Tax-exempt income. Also, any undistributed tax-exempt income from prior years. This is reported as tax-exempt income to the beneficiary.

4) Tax-free distribution of trust principal. This is tax-free to the income beneficiary.

CRATs are favored by "older" donors, often those who want the predictability of regular, unvarying payments of income.

GIFTS THAT PRODUCE INCOME

CHARITABLE REMAINDER UNIT TRUST (CRUT)

Standard, Type I CRUT. The qualified charitable remainder unit trust (unitrust) provides a fluctuating dollar amount of income annually, based on a stated percentage of the fair market value of the trust assets, revalued annually. The payout rate must be at least 5% per year. The term of the CRUT can be for one or more lifetimes (such as a married couple), a term of years not to exceed 20, or a combination of lifetimes and years. Additional gifts *can* be made to a CRUT at any time.

More so than a CRAT, all the variations of CRUTs provide tools to carry out a donor's financial planning and estate planning needs and charitable giving wishes. This section describes a "standard," "straight," "basic" or "Type I" CRUT (a "Stan-CRUT,") in which the trustee pays the unitrust payment amount and can distribute principal if required to make the payment.

For non-cash gifts, the trustee will usually sell the donated property tax-free, and invest the proceeds into a diversified portfolio appropriate to the income beneficiary(ies) and time horizon (term) of the trust. Note that a charitable income tax deduction will be denied by the IRS if the CRUT fails certain probability and percentage tests intended to prevent aggressive abuses that benefit the donor. A donor should have at least $100,000 of assets or cash to give. It will vary among charities but according to some development officers, to justify the cost a donor should have at least $400,000 of assets or cash to give to a CRUT if the charity will be trustee, and at least $500,000 if a corporate fiduciary will be the trustee.

CRUTs can be trusteed by corporate or professional trustees, or by the charitable remainderman itself in the case of larger charities. Because of the many particular IRS requirements of all gifts and of ongoing trust management, in order to avoid self-dealing and maintain tax-exempt status, donor-clients should be strongly discouraged from being their own trustees.

For a standard CRUT, if the trust earns less than the stated annual payout percentage the trustee must invade principal to meet the required payment. If the trust earns more than the stated annual payout percentage the excess income is added to principal, which can increase the following year's payout to the income beneficiary.

While the remainder beneficiary of a qualified charitable remainder trust must be a true "§170(c)," charitable organization, note that in some cases the donor may reserve the right to change the charitable remainder beneficiary(ies).

Four-Tier Payout. Income from a charitable remainder trust is income-taxable to the beneficiaries. The trustee must pay income in the following order:

1) Ordinary "net income" (interest and dividends). Also, any undistributed ordinary income from prior years. This is reported as ordinary income to the beneficiary.

2) Capital gain income--short-term first, then long-term. Also, any undistributed capital gain income from prior years. This is reported as capital gain income to the beneficiary.

3) Tax-exempt income. Also, any undistributed tax-exempt income from prior years. This is reported as tax-exempt income to the beneficiary.

4) Tax-free distribution of trust principal. This is tax-free to the income beneficiary.

CRUTs are favored by "younger" donors, who may still be working, who have a greater tolerance for fluctuating amounts of income, or who may wish to receive less (or no) income now in exchange for greater amounts of income later. Other types of CRUTs, with uses in certain situations, are discussed in the following pages.

GIFTS THAT PRODUCE INCOME

CRUT VARIATIONS
Types II - IV CRUTs

A theme common to Types II, III and IV CRUTs is a delayed payout feature, beneficial to clients for whom the trust is, at least in part, a "retirement plan in disguise."

Net Income, Type II CRUT. A "NI-CRUT" works the same as a standard CRUT, except that the income beneficiary receives the *lesser* of the unitrust payment amount or the trust's net income. If the trust earns less than the stated annual payout rate the trustee may *not* invade principal to meet the stated payout rate.

A NI-CRUT can be used for a patient donor with a long time horizon, who believes that trust principal will grow and increase income over time.

Net Income Makeup, Type III CRUT. A "NIM-CRUT" works the same as a NI-CRUT, except that the trustee keeps track of shortfalls and is required to pay "make up" payments in years when there is excess income until the accumulated deficiencies are satisfied.

A NIM-CRUT can be beneficial to an entrepreneur about to sell a business, who wants to sell his or her interest in a tax-favored manner and needs little or no current income, while creating a future income stream. Note, however, that for this strategy to be successful there are key timing and other requirements that must be observed well in advance of any sale.

The grantor-income beneficiary of a NIM-CRUT, who needs little or no current income, can increase his or her economic rewards by coordinating with the trustee to intentionally delay paying the income until the occurrence of a future date or event, such as retirement. The accumulated deficiencies mentioned above can be significant, allowing a NIM-CRUT to truly be the tax-favored "retirement plan in disguise."

"Flip," Type IV CRUT. A Flip-CRUT begins as either a Net Income or Net Income Make-up CRUT, but then transforms ("flips") into a standard CRUT upon the occurrence of a future event or a specific date. The triggering event is often the sale of an illiquid asset like a piece of land.

A Flip-CRUT can be used for a patient donor who needs little or no current income, but holds a piece of, say, undeveloped, low basis realty the donor believes will be valuable someday and wishes to sell in a tax-favored manner. The asset contributed must be "marketable." Treasury Regulations define unmarketable assets as those that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. Note that any NIM-CRUT deficiency is forfeited when the trust flips to a Stan-CRUT.

The "market" for a Flip-CRUT is not large. In the right circumstances, a Flip-CRUT can also be beneficial to an entrepreneur about to sell a business or a client who has closely-held stock in a business which will likely go public or be the subject of a lucrative acquisition, both of whom want to sell their interest in a tax-favored manner while creating a future income stream. Note, however, that for this strategy to be successful there are key timing and other requirements that must be observed well in advance of any sale.

PART 2: TOOLS OF PLANNED GIVING

IMPORTANT TOOLS TO KNOW

Wealth Replacement Trust. Clients typically benefit only themselves when they create a charitable remainder trust or gift annuity. In doing so, they will often donate highly appreciated low-yielding assets. Because those assets can be a significant portion of their "estate," clients may also not want to penalize their descendants. For clients who are insurable, the *inter vivos* Wealth Replacement Trust (WRT) can be the perfect answer.

A WRT is simply an irrevocable life insurance trust (ILIT). The purpose of the WRT is to replace the value of the assets donated with tax-free cash, which can be distributed as the client(s) wish (often as set forth in their will or revocable living trust) and can include multigenerational planning. A WRT/ILIT will often purchase a new life insurance policy, but can receive an existing policy subject to the 3-Year Rule.

Coupling a CRT with an ILIT can be attractive to clients because the life insurance premiums can be offset by either distributions from the CRT or CGA, or from amounts the clients would have paid in income taxes if there was no charitable tax deduction for the assets donated. Depending on the situation, clients may even be able to increase their descendants' "inheritance"! Furthermore, if the income beneficiaries are a couple, the ILIT can be a joint trust holding a survivor life or "second-to-die" policy, which can either be cheaper to maintain or allow more life insurance for the same premium payment.

Note that if the CRT and ILIT are established at about the same time, the clients may have to pay the first-year life insurance premium out-of-pocket, because CRT or CGA payments are typically not made until the end of each quarter or year.

CHARITABLE LEAD TRUSTS

A charitable lead trust (CLT) is, essentially, the inverse of a charitable remainder trust. A qualified CLT is an irrevocable trust in which the income (lead) interest is assigned to charity, for a period of years, and then the remainder passes to predetermined beneficiaries, usually the donor's children or grandchildren. It is frequently used to transfer valuable--often income-producing--assets to a younger generation at little or no transfer tax cost.

CLATs and CLUTs. Like the CRT, there are two types of CLTs. In a charitable lead annuity trust (CLAT) the annual income payout to charity is a fixed dollar amount or fixed percentage of trust assets, regardless of trust investment performance. In a charitable lead unitrust (CLUT) the charitable payout varies somewhat annually based on the value of trust corpus. The amount of the gift and estate tax deduction depends upon the number of years income is to be paid to charity, interest rates, the size of the annual payments (and perhaps investment results achieved by the trustee).

Because the primary purpose of a CLT is to pass valuable assets to a younger generation with minimal transfer tax cost, most CLTs are CLATs. CLUTs are more difficult and expensive to administer because they require more bookkeeping and regular valuations of trust assets. More importantly, because the amounts passing to charity are predictable, only a CLAT can allow a client to "zero out" the gift. Zeroing out employs an IRS-approved formula whereby the present value of the charitable interest equals the fair market value of the assets transferred to the trust.

Unlike with CRUTs, there are no "net income" or "flip" options for CLUTs. On the other hand, CLTs have no practical maximum term, which is important to a zeroing out computation, or to minimize the risk the trustee will have to invade principal to make payments or if the donor anticipates the value of trust assets will grow slowly over time. CLTs have no minimum payout. While CLUTs can accept additional contributions, this should generally not be attempted for CLATs.

Non-Grantor and Grantor CLTs. The donor must chose the tax treatment of the trust when it is created. There are two options. In a non-grantor CLT the trust's income each year is not taxable to the grantor (donor). The donor receives no income tax deduction for creating the trust, but does receive a sizeable gift tax deduction based on the value of the charity's right to receive income. Recall the transfer (gift and estate) tax deduction is typically the benefit sought when creating a CLT. CLTs work best for assets that generate their own income, such as a securities, income-producing real estate or interests in a closely-held business.

In a grantor CLT the trust's income each year is taxable to the grantor (donor). The donor does receive an income tax deduction based on the charity's right to receive income, but does not receive a gift tax deduction.

Regarding trusteeship, the best (and perhaps only) candidate will be a corporate fiduciary or a truly independent trustee. Because CLTs can exist many years and trustee decisions can affect the size and composition of the remainder share, charities decline the job. Donor-clients should not act as trustee (mostly to avoid violating the self-dealing rules), and absolutely cannot be trustee if the client wishes to give the trustee discretion to choose or change the charitable beneficiary(ies), or the trust gives the trustee control over distributions to charitable beneficiaries. Under IRC § 2038 these powers will cause all the CLT assets to be included in the donor-client's taxable estate! According to some development officers, to justify the cost a donor should have at least $1,000,000 of assets or cash to give to a CLT.

Overall, there are many more CRTs than CLTs. Of the CLTs that are created, the significant majority are non-grantor CLATs. CLTs can be established *inter vivos* or testamentary, and work best when prevailing interest rates are low.

CLTs are a sophisticated financial and estate planning tool, and there are a number of ways to use it in combination with other trusts and entities that are beyond the scope of these materials. While a CLT's benefits can be dramatic, its "target market" is limited. Primarily that will be affluent donors who do not need access to the CLT assets and are willing to part with them, whose children are doing well and do not need the CLT assets in the short to medium run (or ever), and maybe with young grandchildren who can (or should) wait many years to receive the trust assets. Another factor may be when the donor wishes to help the charity he or she has identified sooner rather than later. Ideally, the CLT assets generate their own income, and often will be assets like real estate that the client wants to keep intact and "in the family."

OTHER TOOLS TO KNOW

Donor Advised Fund. Clients may want to have some control over their benevolence, but do not have the several million dollars required to start and maintain a private foundation. Donor advised funds (DAFs) are often the answer, and they are among the fastest-growing vehicles for personal philanthropy.

Most donor advised funds are sponsored by community foundations, such as the Denver Foundation, Colorado First Foundation or the Community Foundation of Northern Colorado. Big stock brokerages such as Charles Schwab, Vanguard and Fidelity Investments also have affiliated DAFs. Note that while nominally independent, the organizations offering DAFs are divisions of those financial institutions.

To create a DAF the donor agrees with a public charity to donate to a specifically named account. The agreement allows the donor (or others, such as the client's children) the privilege of recommending grants from the fund to charities of the "advisor's" choice. The foundation manages the fund's investments, and the foundation's staff is available to screen and make suggestions as to grant recipients. It will vary among the sponsor-charities but DAFs can be established for as little as $10-15,000.

Additional gifts to a client's DAF can be made at any time. Because the gifts are made to a public charity, the gifts yield the higher AGI income tax deduction for gifts to a public charity rather than the lower limits applicable to a private foundation. Note that a client's DAF can *be* the charitable beneficiary of the client's charitable remainder or charitable lead trust!

Conservation or Development Easements.

From Chapter 6, "*Inter Vivos* Gifts," by Mark Masters in *The Orange Book: Estate Planning Handbook* (CLE, Inc. 2019 Supp.).

Conservation or Development Easements

A landowner with realty having agricultural, scenic, environmental, historic, or development value who wishes to preserve its current use or façade for reasons of altruism or a desire to encourage his or her issue to continue the family farm or ranch may wish to consider placing a conservation or scenic easement upon the realty. I.R.C. § 170(h). Such an easement may exist for a set term or in perpetuity, and can preserve the current use of the land or façade, reduce the land's value for estate and gift tax purposes, and may even provide income to the landowner in an exceptional situation. *See generally* § 45.3.10 of this *Handbook*.

A donor can receive an income, gift, or estate tax deduction under I.R.C. § 170 for a qualified contribution of certain undivided partial interests in real property for conservation purposes. If it meets all the tests, a deduction is available for a conservation easement on even a relatively small parcel. *Glass v. Comm'r*, 471 F.3d 698 (6th Cir. 2006) (10 acres); Treas. Reg. § 1.170A-7. To be income tax deductible, the interest donated must be unencumbered. *Kaufman v. Comm'r*, 134 T.C. No. 9, No. 15997-09 (2010). Also, the gift of a conservation easement must be truly gratuitous: in a 2013 Tax Court case, the court denied a charitable deduction when a Colorado county required a conservation easement in exchange for permission to build a personal residence. *Pollard v. Comm'r*, T.C.M. 2013-38; note that the Tax Court also assessed the taxpayer a penalty for substantial understatement of taxes.

When making a conservation easement, the donor surrenders rights to develop or use some or all of the subject realty or structure in specified ways for the period stated. The gift of the easement can be made *inter vivos* or after death if the grant is timely made pursuant to I.R.C. § 2031(c)(9). The easement holder can be an organization sympathetic to the business or personal interests of the donor, such as the Colorado Cattlemen's Agricultural Land Trust or a county historical society. In all cases, the easement holder must be a qualified organization (QO).

The value of a conservation or historic façade easement for tax purposes is generally the difference between the fair market value of the property before the encumbrance of the easement and the typically lower fair market value of the realty after the contribution. Treas. Reg. § 1.170A-14(h)(3)(i). Examples of the "before and after" test for valuation of the contributed easement can be found in Treas. Reg. § 1.170A-14(h)(4), Ex. (4), (7), and (12). If the donor is lucky enough to find a sales record of a comparable easement, the sale price can be used to determine the easement's fair market value. However, since sales of such easements are rather rare and conservation easements are typically donated and not sold, the donor will most likely be forced to use the "before and after" valuation method. In *Hilborn v. Commissioner*, 85 TC 677 (1985), the tax court ratified the use of the before and after valuation method to set the value of the charitable donation of a façade easement. *See also Clemens v. Comm'r*, T.C.M. 1992-436, and *Symington v. Comm'r*, 87 TC 892 (1986).

Donors of conservation easements can reduce their adjusted basis in the portion of the realty retained by the amount of the total adjusted basis of the property allocated to the property interest contributed. Treas. Reg. § 1.170A-14(h)(3)(iii). The federal charitable deduction for a conservation easement can be applied against up to 50 percent of the donor's adjusted gross income (not the usual

30 percent) for the year of the gift, and any unused amount of the deduction can be applied ("carried forward") for up to 15 years (not the usual five). I.R.C. §§ 170(b)(1)(E) and 545(b)(2); Pub. L. No. 111-312. In addition, qualifying farmers and ranchers can deduct up to 100 percent of their income. See 521 T.M. portfolio and IRS Notice 2007-50 for guidance as to the deduction.

I.R.C. § 2031(c) allows an exclusion from a decedent's taxable estate of up to 40 percent of the value of land subject to a "qualified conservation easement," up to a cap of $500,000. Note that there is a carryover of the decedent's income tax cost basis over that portion of the realty excluded from the gross estate by reason of the easement. There are a handful of other restrictions on this exclusion, most notably that (1) the "land subject to a qualified conservation easement" must be within the United States or a possession; (2) must be owned by "the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death"; and (3) a conservation easement must prohibit more than *de minimis* commercial recreational activity. I.R.C. § 2031(c)(8).

Any restrictions that apply to a donor generally also apply to his or her successors in interest. Treas. Reg. § 1.170A-14(g)(1). However, contributions of remainder interests are not deductible if life tenants use the property in a way that negates or diminishes the donor's conservation purpose. *Id.*

Colorado offers an incentive worth noting for conservation easements. Colorado provides a relatively generous state income tax credit of as much as 50 percent of the fair market value of the conservation easement for a qualifying charitable donation of a perpetual "conservation easement in gross" over Colorado real property up to an amount derived from a statutory formula. The donation must be made to a governmental entity or an I.R.C. § 501(c)(3) exempt organization that has been in existence for at least two years prior to receiving the easement. The credit is based on the fair market value of the easement and can be sold or used (or partially refunded if a TABOR surplus exists). The ability to transfer the tax credit benefits most potential creators of conservation easements, who are generally land-rich and cash-poor and for whom the credit would have limited utility because they do not have high taxable incomes.

The credit can be claimed by Colorado residents, C corporations, trust, estates, and by partners, shareholders, or members of pass-through entities. A taxpayer can also transfer all or part of a credit to a "transferee" that meets the lengthy C.R.S. § 39-22-522(7) definition of a taxpayer who can claim the credit.

Under the Colorado definition of C.R.S. § 38-30.5-102, "conservation" includes land (or the airspace above) preserved for outdoor recreation and education; protection of natural habitats for plants, fish, and wildlife; preservation of open space for scenic enjoyment; and preservation of historically important land or structures.

Overstated conservation easement documentation and fraudulent appraisals have come to light, which has resulted in scrutiny of appraisers and easement methodology by the IRS, and legislation and increased oversight at the state level. Landowners wishing to create conservation easements must pay a sizeable fee, and the tax credits are issued only after a lengthy process that includes review of the easement agreement and appraisals, biological studies, and other materials.

> Increased scrutiny of conservation easements began after June 30, 2004, when the Internal Revenue Service released IRS Notice 2004-51 [2004-2 C.B. 31]. . . . Despite the IRS's warning, taxpayers continue to challenge and push the

> conservation easement rules to their limits. Recently, many of these controversies have worked their way into the judicial system and are available for the education of attorneys.

Jeffrey R. Bergstrom, "Recent Developments with Conservation Easements," 43 *Colo. Law.* 53, 53 (March 2014).

Colorado HB 08-1353 gave expanded jurisdiction to the Colorado Division of Real Estate to conduct investigations into conservation easements and their supporting appraisals, and including the creation of the Conservation Easement Oversight Commission to review conservation easement applications, easement appraisals, and, broadly, any other issues referred to the Commission by any state agency. C.R.S. § 12-61-721. In addition, practitioners should be aware that the Colorado Department of Revenue has promulgated a set of conservation easement tax reporting forms in an attempt to stem further abuses. DR forms 1303, 1304, and 1305.

Unrealistic, overstated valuations will likely trigger challenge by both the IRS and Colorado Department of Revenue, especially when the regulators discover that the sum of the value of the easements greatly exceed the original unencumbered value of the land. *Basin Wind and Energy, LLC v. Snell & Wilmer, LLP*, 2013-CV-31635 (Denver County Dist. Ct.); *The Bluffs Destination Resorts, LLC v. Greenberg Traurig LLP*, 2011-CV-3219 (Denver County Dist. Ct.).

Sole-member limited liability companies that are disregarded for federal tax purposes under Treas. Reg. § 301.7701-3 will not qualify for the Colorado credit because such an LLC is not a pass-through entity and does not qualify as a "taxpayer." C.R.S. § 39-22-104(1). Non-resident individuals will also not qualify for the Colorado credit.

Among other restrictions on the Colorado conservation easement credit, only one credit may be claimed per year by the donor of such an easement, but if the entire credit is not applied against Colorado tax in the year the credit is claimed, any unused portion may be carried forward for up to 20 years. Additional credits may not be claimed by a taxpayer during any year in which a prior conservation easement credit is being carried forward.

Guiding a client through the process of a conservation or development easement requires sophisticated advice and drafting. Robert Cutter, "Conservation Easements: A General Practitioner's Overview," 19 *Colo. Law.* 221 (Feb. 1990). In addition, the value of the donation of the easement must be supported by a specialized and exhaustive appraisal that takes into account, if at all possible, empirical analysis. Because of earlier abuses, proposed conservation easements in Colorado can expect a greatly heightened level of scrutiny and oversight by the IRS and Colorado regulators. Attorneys and clients who are considering granting a conservation or façade easement should work with specialized counsel. *See also* Downing, "Terminating and Amending Conservation Easements in Colorado," 45 *Colo. Law.* 8 (Aug. 2016).

In summary, then, agricultural clients can be told:

> You keep your land. You keep it in the agricultural use in which you've always used it.
>
> You identify the important conservation qualities of your land and then place a legal restriction upon its development, and give the charity the responsibility to see to it that its conservation features are protected.
>
> Subject to the restriction against development of a conservation easement, you can mortgage or sell the land to others or leave it to your heirs.
>
> Since it's the speculative development value which is pushing up the value of your land for estate tax purposes, placing a restriction on its development will return it to being only valued for agricultural purposes, thus lowering its value in your estate.
>
> The "development value," the difference between the full fair market value of your land without the restrictions and its "ag value," its value as a farm or ranch only subject to the conservation easement, can be gifted to the charity for conservation purposes.
>
> Because such gifts can produce a large charitable deduction, perhaps greater than you can use against normal income, in some cases the charity may purchase part of the easement for cash, creating a capital gain to absorb the balance of your deduction.
>
> A qualified conservation easement will not prevent the property from also qualifying for special use valuation under IRC § 2032A.

EXTRA-LARGE GIFTS

Charitable gifts can be made to either public charities, or to private foundations for the fortunate few clients who can afford a private foundation and are willing to have the foundation be subject to extra administrative and financial burdens. Supporting organizations will also be mentioned.

Private Foundation. Sometimes known as a "family foundation," a private foundation is a separate income tax-exempt entity, created either as a non-profit corporation or as a trust. The private foundation accepts charitable contributions from a limited number of donors, perhaps only one or two of the foundation's founders. The governing board of the private foundation manages and administers its assets and makes distributions for charitable purposes to other charities. Most private foundations are corporations.

A private foundation is the ultimate in "designer philanthropy" because generous donors can have an impact on an array of organizations they favor over an extended period of time and can provide family members and others with opportunities to influence charitable giving for that long period of time.

However, private foundations are subject to the Private Foundation Rules--a number of restrictions which mandate minimum annual distributions and prohibit self-dealing, imprudent investments, excess business holdings, and certain transactions between the foundation and its founders, donors, or parties related to them. There are restrictions on the income tax deductibility (lower AGI income tax deduction) of contributions to private foundations versus contributions to public charities. A private foundation must have sufficient resources to employ at least one manager with specialized expertise, as well as provide for its own accounting and investment management. A private foundation must also file informational tax returns each year (open to public view) and pay annual income taxes!

As with donor advised funds, a private foundation can *be* the charitable beneficiary of the client's charitable remainder or charitable lead trust. On the other hand, with the much higher cost of creation and annual operation, lower income tax deductibility and several-million dollar threshold to create a private foundation, it is easy to see why "smaller" donors are using DAFs instead.

Supporting Organization. Fortunate clients who would like to receive the income tax benefits of contributions to a public charity without the disadvantages associated with creating a private foundation, and who have a public charity they want to support in a significant way and are comfortable with for the long haul, may wish to alternatively consider creating a supporting organization.

A supporting organization is either "operated, supervised or controlled," or is "supervised or controlled in connection with," or is "operated in connection with," a public charity. There are three types of supporting organizations, a discussion of which is beyond the scope of these materials. The important factor is that the supporting organization is *de jure* controlled by the public charity it supports and is integrated into the charity's operations to a large degree. Supporting organizations have minimum distribution requirements and cannot be controlled by the donor (though the donor can participate in the organization's management).

SELDOM-USED TOOLS

Pooled Income Fund. Though they have gone out of favor, pooled income funds (PIFs) have been called "charitable mutual funds." PIFs may be thought of as a "CRT for small rollers." It will vary among charities, but when offered PIFs can be established for as little as $5,000-10,000.

A pooled income fund is a trust maintained by a charity in which all gifts are commingled for investment purposes, with each donor receiving a proportionate share of the income earned. Gifts are irrevocable, and upon the death of the income beneficiary that portion of the fund representing the donor-beneficiary's interest will be removed and transferred to the charity.

The donor receives the same four benefits of income-producing gifts like a charitable remainder trust or gift annuity, but on a smaller scale because gifts to PIFs are often smaller to begin with. As with other income-producing gifts the donor will receive the maximum benefit from a gift of appreciated, unencumbered assets, such as appreciated securities with a low yield (or cash). Note that PIFs cannot accept tax-exempt securities, but can usually accept additional gifts.

When offered, PIFs can have "flavors," such as a growth fund, an income fund, etc. PIFs often have the same "market" as deferred gift annuities discussed above: Younger donors in their peak earning years, who are looking for an income tax deduction that year, perhaps as a supplement to other retirement income.

Bargain Sale. A bargain sale is a part-sale part-gift. A bargain sale occurs when a donor sells property to a charity for less than fair market value. The IRS views the transaction as having to elements--a sale and a gift. The donor is allowed a charitable income tax deduction for the difference between the sale price and the fair market value of the asset. While clients will receive some immediate cash, they will also be responsible for capital gains income tax on the portion of the property that was a sale.

Charities can be wary of a proposed bargain sale in certain situations. These situations include encumbered property, assets the donor has not held long enough to get long-term capital gain treatment, stock redemption plans, tangible personal property, and assets that are not usable in the charity's purpose or which cannot be readily re-sold.

PART 3: PLANNING WITH CHARITABLE GIFTS

THE BEST CANDIDATES FOR TRADITIONAL CHARITABLE GIVING

The best candidates for traditional charitable giving, both large and small, have these personal characteristics:

1. Over 50. Better yet, those who are retired, and for whom their retirement is financially secure even considering longevity.

2. Established connection to one or more charities. Perhaps they are a current recurring (annual) donor.

3. Established pattern of community involvement or giving. Perhaps they do not give large amounts of money, but give significant amounts of their time, or are just generally "involved."

4. No children. Those who have no "natural objects of their bounty" are ideal candidates for planned charitable giving because they have no one to second-guess their gift(s).

5. Well-to-do children. Those who have adult children who have respectable (perhaps taxable) estates themselves and do not "need" (or maybe want) an inheritance.

UNSUSPECTING "SPECIAL" CANDIDATES FOR CHARITABLE GIVING

Clients in certain situations simply do not realize what planned charitable giving can accomplish for them--unless you suggest it.

1. People with inevitably-taxable estates. High estate tax thresholds result in many fewer of these candidates currently, but those who remain in this category are multi-millionaires with often-complicated personal and financial situations. They may be Type A personalities who like to be "in charge," and may also have a professed aversion to taxes or perceived interference by "the gumment." Sometimes for these candidates, the choice can be reduced to a portion of their estate involuntarily going in taxes to bureaucrats and politicians, or the client deciding who receives that same amount and with some control over the manner in which their chosen beneficiaries receive it.

2. Working people with a big "income event" this year. Clients who have widely-variable income, like commission salespeople, realtors and attorneys. If these people make a big sale or have a very good year, they can be looking for income tax deductions before the year-end to minimize that year's income taxes (particularly if they have not withheld enough). A gift that year to their CRUT, PIF, or creating or adding to a deferred gift annuity can provide welcome income tax relief, while supplementing other sources of retirement income.

3. Entrepreneurs contemplating cashing out. Some entrepreneurs build businesses for the sole purpose of the White Knight buy-out; others are motivated by the challenge of building a business, not maintaining it once it becomes mature. Factors in common are the potential for enormous capital-gain income taxes on the sale of a very low basis asset with gigantic appreciation. As noted above, for a client who needs little or no current income, a Type III CRUT (NIM-CRUT) can provide welcome income tax relief, while creating a future retirement income stream.

   NOTE: Timing is everything! To achieve the maximum benefit--and to avoid challenge by the IRS as a prohibited "step-transaction"--the gift to the NIM-

CRUT of the business interests to be sold <u>must</u> be made <u>before</u> any papers are signed, including even a Letter of Intent.

4. <u>Farmers and Ranchers</u>. As a population, those involved in agriculture can be Land-Rich and Cash-Poor. Generally, they are also older than the overall US population, perhaps at or after retirement age, and have their wealth heavily concentrated in an illiquid asset (land) with very large appreciation. Moreover, some may have the situation where none of their children or grandchildren want to take over the farm or ranch. Planned charitable giving can sometimes help. Consider for your client: a CLAT; a life estate (see below) over some or all of the land; a conservation easement over some or all of the land; a Type IV CRUT (Flip-CRUT) gift of some or all of the land. With certain of these gifts, consider suggesting your clients retain some or all of the mineral or water rights.

DON'T OVERLOOK
a/k/a PLANNED GIVING FOR THE REST OF US

Gift of Appreciated (and Under-performing) Stock.

Gift of an Old Life Insurance Policy. Alternatively, the charity can be designated the beneficiary of the policy.

Gift of a Small Annuity Contract.

Charitable IRA Rollover: Potential donors are surprised to learn that individual beneficiaries will pay income tax on gifts of qualified retirement plan assets. Clients who are over age 70½ can contribute up to $100,000/year from an IRA to a charity and have the donations count toward the donor's annual RMD withdrawal. Called a QCD (qualified charitable distribution), this is both a convenient way to contribute to charity, and it does not increase the client's adjusted gross income (AGI), which helps reduce income taxes on Social Security and avoid Medicare premium charges. No charitable deduction, but no income taxes, either.

Note, the QCD check must be payable directly to the charity--it cannot be distributed to the client first and then donated later. The recipient must be a 501(c)(3), public charity, meaning that private foundations and some DAFs will not qualify. And in addition to making sure the charity can receive such a gift, the client should check with the IRA custodian to see if there are any specific requirements or forms needed.

Gift From Qualified Retirement Plan (IRA or 401-k). Potential donors are surprised to learn that individual beneficiaries will pay income tax on gifts of qualified retirement plan assets. With this tool, the client simply names the charity or charities the beneficiary of some or all of the retirement plan account.

Remainder Interest/Life Estate in Real Property: A residence, an "odd" piece of land, part or all of a farm or ranch that no heir wants. (But see below.) Of course, the life estate can be reserved for one or both client-spouses, who have the right to live there and use (or lease) the land for the rest of their live(s) or a term of years.

Clients can be told that: Your chosen charity will take over your cherished land upon your passing, and manage it for its charitable purposes; the present gift of your place generates a current charitable income tax deduction similar to that generated by the creation and funding of a CRT; a life estate gift can further your and the charity's conservation purposes if your place would have important conservation qualities such as open space, wildlife habitat, scenic views or watershed.

Beneficiary Deed of Personal Residence. Increasingly popular.

Gift to Charity in Will or Trust, including as a contingent beneficiary and especially for small families.

Gift of Car, Motorcycle, Boat, RV: Unused, broken-down, or for a client who shouldn't be driving.

Gift of an Unwanted Cemetery Plot--to the right charity. (See below.)

Small POD Account. The donor can use the money during life if needed, at death it passes directly to charity.

DON'T BOTHER WITH

There are certain *potential* gifts that you and your clients should not waste your time and money trying to pursue. The costs, time and headaches are probably not be worth it. Furthermore, the charity may refuse the gift!

Anything Mortgaged. Realty or personalty subject to indebtedness donated to charity will be a bargain sale. The indebtedness will be treated as taxable income to the extent it exceeds the donor's tax basis in the property, regardless of whether the charity or charitable trust agrees to assume or pay the indebtedness. Furthermore, for debt-financed real estate acquired by a charitable trust and later sold, all of the gain will be subject to excise tax as Unrelated Business Taxable Income.

Brownfields. Charities will generally refuse real estate with environmental problems. For commercial or agricultural realty (and sometimes a personal residence) your client should expect to pay for an appraisal, a Phase I environmental audit, and maybe a Phase II environmental assessment. The remediation costs and potential bad publicity of the contaminated site are often not worth it to the charity.

Also, charities may not accept realty that is subject to adverse zoning, deed reservations or easement restrictions that affect marketability.

Closely-held or Restricted Securities. The transfer and valuation of closely-held or restricted stock is complex and depends on the specific conditions and requirements of the units. Often, the only buyers for the stock are people involved with the entity, who fully expect to buy the stock back from the charity. These transactions are easily challenged by the IRS as step-transactions, that is, pre-arranged agreements to sell the stock and avoid paying tax.

Gifts in Kind That a Charity Can't Use. Under the Related Use Rule, a donor is allowed a deduction for the fair market value of tangible personal property only if the item is related to the charity's tax-exempt purposes. If not, the deduction is limited to the *lesser* of the donor's basis or the FMV.

Timeshares. Charities don't want timeshares for the same reasons adult children of decedents don't want them!

ACRONYMS AND ABBREVIATIONS

ACGA	-	American Council on Gift Annuities
AFR	-	Applicable Federal Rate
CGA	-	Charitable Gift Annuity
CLAT	-	Charitable Lead Annuity Trust
CLT	-	Charitable Lead Trust
CLUT	-	Charitable Lead Unitrust
CRAT	-	Charitable Remainder Annuity Trust
CRT	-	Charitable Remainder Trust
CRUT	-	Charitable Remainder Unitrust
DAF	-	Donor Advised Fund
FMV	-	Fair Market Value
IRC	-	Internal Revenue Code
IRS	-	Internal Revenue Service
LTCG	-	Long-Term Capital Gain
NICRUT	-	Net Income Charitable Remainder Unitrust
NIMCRUT	-	Net Income with Makeup Charitable Remainder Unitrust
PIF	-	Pooled Life Income Fund
QCD	-	Qualified Charitable Distribution
SCRUT	-	Standard Charitable Remainder Unitrust
STCG	-	Short Term Capital Gain
UBI	-	Unrelated Business Income
UBIT	-	Unrelated Business Income Tax
UBTI	-	Unrelated Business Taxable Income

COLORADO SENIOR LAW HANDBOOK

2019 EDITION

Philanthropy and Planned Giving

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Mark D. Masters, Esq.

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Chapter 18
Philanthropy and Planned Giving

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SYNOPSIS

18-1. About Philanthropy

18-2. What Are Planned Gifts?

18-3. Types of Planned Gifts and the Advantages to the Donor

18-4. Conclusion

18-5. Resources

18-1. About Philanthropy

Throughout life, you may be asked to make donations to individuals or charities, and, after considerable discerning thought, may give to those to which you feel a connection. However, in the "golden years," you may be asked to consider a different type of gift: your legacy.

What can you leave the next generation? This question may not be as difficult to answer as: *How* will you leave your gift to the next generation? The decision about "how" to leave a legacy gift may seem complex at first glance. After all, financial gifts given throughout your lifetime probably came from your income, but now you are deciding about gifts from your accumulated wealth. This chapter is designed to provide some insight into philanthropy as an activity and as a philosophy, help you find information about your favorite charity, and provide you with options with which to plan your gift.

A great essay on the topic of deciding how one should engage in appropriate philanthropy comes from the book, *Philanthropy: Voluntary Action for the Public Good,* by Robert L. Payton. It is an essay on friendship, charity, the human condition, and the methods and values of science and morals. Payton's reflections on reason and emotion in philanthropy are inspired by Thomas Jefferson's famous letter to Maria Cosway entitled, "A Dialogue Between My Head and My Heart," in which Jefferson theorizes that common sense and emotion can often be at odds as we consider charitable intent and acts. Payton postulates that even today, we all have conflicts in deciding how and when and to whom to give — conversations between our Head and our Heart. What gift makes sense in today's world, where homelessness, famine, and constant human needs are worldwide and ever-present? Will my gift make a difference? Can I be sure that my gift will be used appropriately? We present a part of the essay here to stimulate your thoughts about how to evaluate the question of determining your giving nature.

From Payton's essay:

> Beyond friendship, in our less personal relations in society at large, Jefferson counsels against the misleading influence of narrow self interest. The Head leads us astray when it intrudes in the affairs of the Heart. He illustrates his theme with the example of a weary soldier seeking a lift on the back of Jefferson's carriage. Jefferson's self interest advises against it: His Head argues that there will be other soldiers further on; eventually we'll put too much of a burden on the horses. Jefferson rides on, but his conscience gets the better of him: It may not be possible to help everyone, his Heart pleads, but we ought to help those we can. The logic of compassion wins out, but too late, because when Jefferson turns back to find the soldier, the soldier has taken another road.

The Center on Philanthropy at Indiana University describes philanthropy in a less complex way:

> It's a powerful feeling, helping others.
>
> You've felt it: The "warm glow" that comes when you do something good for someone else.
>
> You feel it every time you give money to a cause you believe in. But it radiates just as strongly when you volunteer at a community event, participate in a service club, take food to a sick neighbor, or help out a friend.
>
> This feeling is an expression of your concern for others rather than yourself. Of wanting to help fill a need, solve a problem, make life better for someone else. In short, of wanting to take action, voluntarily, for the public good.
>
> This is philanthropy.

Philanthropy is personal and private. Everyone will have a different philosophy and follow his or her own Heart or Head, or both. We hope you enjoy the journey as you come to a decision regarding your own charitable path.

18-2. What Are Planned Gifts?

Planned gifts include a variety of charitable giving methods that allow donors to express their personal values by integrating charitable, family, and financial goals. Making a planned, charitable gift usually requires the assistance of a knowledgeable advisor such as an attorney, financial planner, or CPA to help structure the gift. Planned gifts can be made with cash, but many planned gifts are made by donating assets such as stocks, real estate, insurance, or business interests — the possibilities are endless. Planned gifts can provide valuable tax benefits and/or lifetime income for donors, spouses, or other loved ones. The most frequently made planned gifts are bequests to charities, made through wills. Other popular planned gifts include charitable trusts and charitable gift annuities.

The advantages of planned gifts are many, but some of the more popular reasons for establishing this type of gift are:

1) Providing life income to the donors;
2) Receiving a charitable income tax deduction;
3) Avoiding or mitigating capital gains taxes by gifting appreciated, long-held property;
4) Removing assets from one's estate to lessen the estate tax burden;
5) Turning low or non-income-producing assets into higher income payouts;
6) Fulfilling one's charitable intent by supporting a favorite charity; and
7) Providing a charitable gift while receiving tax benefits *and* maintaining control of the asset during one's lifetime.

18-3. Types of Planned Gifts and the Advantages to the Donor

Bequests

The basic, easiest, and most popular planned gift is a bequest. Many planned gifts to charities are bequests. A charitable bequest is a provision in your will or trust that designates a charity as a beneficiary. Bequests can either be specific (leaving a certain asset or a set sum of money to the charity) or general (leaving a percentage of your estate to the charity). Many charities will help you with the bequest language you'll want to use in your will or trust. It is important to include enough information in the bequest so that your estate administrator or trustee will know to which charity or charities you want your gift directed.

The greatest advantage of bequests to charity is that you, the donor, maintain control over your assets until your death. For this reason, charities consider bequests to be *revocable* or incomplete in nature — that is, the gift is not absolute. If the estate's assets cannot support payment of the bequest to a charity, there is no legal obligation on the part of the estate to make payment. The donor can also change his or her beneficiaries during life and can remove a charity (or any other beneficiary) from his or her will. As in all other types of planned gifts, a bequest can be designated to be used for any purpose that the donor wishes, so long as the gift is not to be used for any intention that is in violation of the law. If you have a particular use to which you would like your bequest directed, the charity will be most pleased if the terms of your intentions are set forth specifically in the will provision so that the charity can use your gift in the way that you intended. If acceptable to you, many charities would appreciate the opportunity to know of your bequest provision and charitable intentions. While you are still living, you could send them the entire will or simply the pages with their particular gift noted thereon. It would be up to you, of course, if you wanted to be publicly thanked and recognized for your future gift by the charity, or you could remain anonymous if that is more comfortable for you.

Retirement Plan Gifts

One way to provide a planned gift to a charity is to include your favorite non-profit organization in your retirement plan documents. You can designate a charity as a beneficiary of your individual retirement account (IRA), 401(k), or other qualified retirement plan. In many regards, if a person is charitably inclined, it is preferable to fund such gift with this type of asset because the proceeds from these accounts are, at death, considered income in respect of a decedent (IRD). This tax law concept is generally defined as taxable income earned but not received prior to death. No matter who the beneficiary is, the income, when received, will be taxed to the beneficiary as it would have been taxed to the decedent. Generally, inherited property is not included in an heir's taxable income, but if a family member receives an IRD asset, he or she will be subject to income tax when the gift is distributed.

When a donor provides at death for a direct transfer from his or her retirement account to a qualified charity, however, the entire value of the IRD assets will go to the charity *tax free*. In addition, the donor's estate receives a charitable estate tax deduction for the entire amount of the gift. Making a gift of IRD can be quite easy. For example, a donor can make a specific bequest of U.S. savings bonds owned at death to a charity, or the donor can simply change the beneficiary designation on his or her retirement account — *e.g.*, IRA, 401(k), 403(b), or defined contribution plan.

Your retirement plan administrator can furnish you with the appropriate designation of beneficiary forms to complete. As in a will bequest, you can authorize a portion or percentage of your retirement assets to be shared by any combination of charities and/or other heirs.

If you have ample retirement income and sufficient qualified retirement plan assets such that taking mandatory distributions adds to your current income taxes or may be subject to estate taxes someday, a variation is the Charitable IRA Rollover. Within some limitations, you may be able to distribute up to $100,000 per year directly to a charity, in lieu of any minimum required distribution to yourself, and regardless of your income or any other donations to charity that year. There is no income tax deduction for a Charitable IRA Rollover,

but you save on the income taxes paid on an ordinary distribution in the year that you make the gift, along with any estate taxes later.

Gifts of Appreciated Stock

If you would like to make a larger gift to a charity, appreciated stock is often a better choice than a cash gift of the same value. By donating securities held long-term (more than one year) to a charitable organization, a donor can avoid capital gains tax on appreciation and receive a charitable deduction for the full fair market value of the donation. If the estate will be subject to federal estate tax, removing assets from the estate can also decrease estate taxes. Taxpayers may be responsible for a 15 percent capital gains tax. Here is an example of the advantages of giving appreciated stock versus the gift of money using a taxpayer in the 28 percent tax bracket and 15 percent capital gains tax.

Giving Appreciated Stock

Value of stock gift (28% tax bracket) = $25,000

Your basis (what you paid for it) in the stock = $5,000

Expected gain from the sale of the stock = $20,000

Savings by contributing the stock to charity:

$25,000 charitable deduction (savings of $7,000 in income taxes ($25,000 x 28%))

$3,000 capital gains tax savings ($20,000 x 15%)

NET COST OF GIFT = $15,000 ($25,000 - $7,000 - $3,000)

Selling Stock to Give a $25,000 Cash Gift

Value of the gift (28% tax bracket) = $25,000

$25,000 charitable deduction (savings of $7,000 in income taxes ($25,000 x 28%))

Capital gains tax on sale of stock with basis of $5,000 ($20,000 x 15%) = $3,000

NET COST OF CASH GIFT = $21,000 ($25,000 - $7,000 + $3,000)

Life Income Gifts

Charitable Gift Annuity (CGA) and Deferred Charitable Gift Annuity (DCGA)

A charitable gift annuity is a contract between a donor and the issuing charity. This is often the gift of choice when a guaranteed present income or future income is desired. Typically, in this gift option, a gift of cash or securities is transferred to the charity of the donor's choice in exchange for a contractual life income paid to the donor or donors at least annually, or deferred to a later date in the case of a DCGA. The income is guaranteed by the issuing charity, and the donor can name himself or herself as sole annuitant or designate a

second annuitant, usually a spouse. A gift annuity can also be purchased on behalf of another party — for example, an adult child. If the CGA is a two-life annuity, the payout will continue until the death of the second annuitant. A portion of the gift is invested by the charity and used to provide income for life, and the remaining portion qualifies as a present-interest gift to the charity, which then entitles the donor to a charitable tax deduction. Some charities require that annuitants be of a certain age — say, 65 — before they can enter into any gift annuity. Some charities also have a minimum dollar amount to fund a CGA.

The American Council on Gift Annuities (ACGA) sets suggested maximum rates for CGAs and DCGAs. The ACGA reviews the rates and changes them periodically, depending upon the current interest rates and current mortality tables. The majority of charities use the rates recommended by the ACGA, and these rates are incorporated into charitable CGA software programs. The annuity payout rate will be determined by the age or ages of the annuitants, although some charities deviate from the suggested rates. (If a charity does not use the suggested rates, be sure to consider whether it has sufficient assets to pay for a higher rate over a long period of time.) In the case of a DCGA, the rate is set at the time the gift is made, but the rate is reflective of what the software program projects the appropriate payout rate will be when the annuitant begins to take payment. Almost all charities that offer gift annuities use software programs that automatically calculate the rate. You can easily request an illustration that will include your variables of amount of gift and age(s) of annuitant(s). This illustration or projection will clearly show the charitable deduction, payout rate, and annuity payment.

Technically, a CGA/DCGA is part gift and part sale, or a *bargain sale*. Think of it as two separate transactions: a gift to the charity and then the purchase of an annuity. The gift portion is the value of the property transferred to the charity minus the present value of the annuity. The sale portion is the present value of the annuity. The payout of any gift annuity depends on the asset that was transferred to the charity. Some of the annuity payment will be tax free, some might be return of capital gain income, and some might be ordinary income. The following is helpful to know:

- *If the donor contributes cash*: The annuity payment is part tax-free return of principal and part ordinary income for the duration of the annuitant's life expectancy.
- *If the donor contributes appreciated, long-term property*: The annuity payment is part tax-free return of principal, part return of capital gain income, and part ordinary income — all for the duration of the donor's life expectancy. Another way to look at it: if a donor transfers this kind of property to fund the gift annuity, he or she is deemed to have sold a portion of the property to the charity and the donor can then spread the capital gains over his or her life expectancy (as opposed to incurring the full amount of the capital gains tax if the same property was sold on the open market and not given to charity).

Another component to consider in a CGA or DCGA is the Internal Revenue Service (IRS) discount rate, which is used to determine the charitable deduction. The rate is the annual rate of return that the IRS assumes the gift assets will earn during the gift term. It is related to the prime interest rate, and is updated monthly.

Basically, the higher the discount rate, the higher the charitable deduction will be, and vice versa. If the charitable deduction is important to the donor, he or she may want to

wait until the discount rate is at an acceptable percentage. Lower federal interest rates mean lower IRS discount rates, which, consequently, mean lower charitable tax deductions for CGA or DCGA annuitants. The upside of a lower discount rate is that the tax-free portion of a gift annuity's payment is maximized.

The CGA or DCGA is a very popular planned gift option. Let us sum up the benefits of this type of gift, which may be attractive to you:

- ▶ It yields income for life (fixed payments).
- ▶ The donor can select the starting date of the income.
- ▶ It gives the possibility of one or two income beneficiaries.
- ▶ It is a guaranteed contractual agreement — payment is an absolute obligation of the issuing charity.
- ▶ The donor desires to make a present gift to a favorite charity.
- ▶ The donor can turn low or non-producing assets into higher-return assets by establishing a charitable gift annuity with cash or securities.

Here's an example of how a gift annuity can work:

Donor profile:

Mr. Brown, age 72, currently owns $25,000 in highly appreciated stock, which is producing low dividends; he purchased the stock over one year ago for $10,000. With retirement approaching, Mr. Brown is considering ways to secure his future income.

Strategy to reduce capital gains:

Mr. Brown establishes a $25,000 charitable gift annuity by donating his highly appreciated stock to a charity. By gifting to charity, his 15 percent capital gains tax ($2,250 or ($25,000 – $10,000) x 0.15) is not immediately due to the IRS but will be paid by Mr. Brown over his lifetime.

Financial benefits:

Annuity: $25,000

Annuity Payout: 5.4%

Annual Payout for Life: $1,350

Immediate Charitable Tax Deduction: $10,377.50 (assumes a 2.2 percent IRS discount rate)

A great advantage of funding a charitable gift annuity with a donation of highly appreciated stock is the reduction of capital gains tax liability. The 15 percent capital gains tax is eliminated on the gift portion of the transfer. Although he will have some capital gains tax

spread out over his life expectancy, Mr. Brown avoids an immediate payment of $2,250 in capital gains tax (15 percent of the gain) that would be due if he sold the securities.

Charitable Remainder Trust (CRT)

A charitable remainder trust is a separate trust arrangement between a donor and a trustee chosen by the donor, and will always involve a legal document establishing the terms of the trust. The trustee can be a bank, trust company, brokerage firm, an individual, a charity, or sometimes even the donor. Under the terms of the CRT, the donor reserves the right to receive payment from the trust or can provide for payment to other beneficiaries. When the trust is dissolved (often at the death of the donor or surviving beneficiaries), the remaining principal is distributed to the charity or charities named by the donor who established the trust. A CRT is an irrevocable planned gift; that is, the donor cannot change his or her mind once the trust is established and he or she receives the corresponding charitable tax deduction. The beneficiary charities can sometimes be changed, but the trust remainder must be paid out to a charitable organization or punitive tax results will occur. As with all planned gifts, if you are considering a CRT, be sure to seek the advice of your advisors, including tax consultants and attorneys.

To fund a CRT, cash, securities, real property, or other unencumbered assets are transferred into a trust. The trustee manages the trust assets and pays the donor's beneficiaries a fixed income for life or for a term of years. CRTs come in a variety of forms, including a fixed income annuity trust, in which the annual income never changes, and a unitrust, in which the assets are valued each year and the income is paid according to the trust's value. CRTs can even be designed to hold real estate and pay no income, but once the real estate is sold, the trust flips into a life income trust (flip unitrust).

Most banks and trust companies that serve as trustees require a minimum of $250,000 to establish this type of planned gift. The administrative costs for managing charitable trusts can be quite high, usually a percentage of the trust's assets. Because the CRT is considered a separate entity, it must file a specialized tax return and can be responsible for other reporting duties, which can make the cost of maintenance too high for smaller-sized accounts below $250,000. Further, preparing the CRT documents can cost a few thousand dollars. The CRT is certainly not for everyone. Fortunately, other options like gift annuities and donor-advised funds exist for the charitably inclined, which have many of the same personal and tax benefits as CRTs but may be established with lower amounts.

The benefits of a CRT, though, especially a unitrust, are numerous: these trusts are extremely flexible, can be established with higher payout rates, can be used to provide support for a surviving spouse, can turn low or non-producing assets into higher payout assets, can receive additional assets during the life of the CRT (in the case of a unitrust), and more. Here is a comprehensive list of the advantages of this type of gift:

- The donor retains the right to receive income for his or her life, the lives of others, or for a specified term of years.
- There is the possibility of multiple beneficiaries.
- Assets transferred into the CRT can be sold and reinvested in higher-income-producing assets.

- The donor has the ability to choose the trustee (and can self-trustee in some cases).
- A CRT can preserve the principal of one's assets while generating life income.
- The donor can elect to receive a fixed income based on the original value of assets transferred or an income based on the value of the assets recalculated each year (annuity trust versus unitrust options).
- The donor can continue to fund the CRT if it is a charitable remainder unitrust (CRUT) (assets revalued each year). If the CRT is established as a fixed income trust (a charitable remainder annuity trust), the donor cannot make additional gifts to the trust in the future.
- The donor receives a charitable income tax deduction in the year that he or she funds the CRT or makes any additional contribution (CRUT). Unused portions of the income tax charitable deduction may be applied in up to five future years.
- The donor chooses the amount of the payment within a range (generally, a percentage of the initial gift amount or value of assets).
- The trustee can tailor the investment strategy of the CRT and the taxable character of the income to meet the unique needs of the donor.
- The donor can choose one or more charitable organizations to share in the trust principal upon termination of the CRT and can reserve the right to change any charity.
- The donor can change the frequency and timing of the payments (monthly, quarterly, semi-annually, or annually).
- The donor can reduce potential estate taxes by removing the assets from his or her estate.
- The donor can avoid/mitigate capital gains tax by funding the trust with appreciated property.

A CRT can be an excellent strategy to use with illiquid assets, and CRTs come in several varieties. Consider the following example. John and Jane Green, ages 72 and 70, jointly own undeveloped land that is currently valued at $550,000 and has a cost basis (the price they paid for the property) of $70,000. They are in a 35 percent tax bracket, and property taxes run $10,000 per year. They owe nothing on the property and are in a 15 percent capital gains bracket. The property does not produce any income. If they sold the property, the Greens would incur capital gains of $480,000. Therefore, their capital gains tax would be $72,000 ($480,000 x 0.15) if they sold the land. At the 35 percent tax bracket, the Greens are subject to the 3.4 percent Affordable Care Act surcharge on capital gains.

The Greens learned that they could convert the property to new income with favorable tax benefits using a charitable remainder flip unitrust. They transferred the land to a 5 percent flip unitrust, retaining a joint and survivor income interest. When the land is sold, the trust holding the property "flips" to a regular CRT unitrust and the proceeds from the land sale are reinvested in assets that produce an income for the Greens. When the trust is dissolved, *i.e.*, at the death of the survivor, the remaining assets will go to a charity of their choice.

By transferring the land to a flip unitrust, the Greens accomplished the following:

- ▶ Made an irrevocable gift to one or more of their favorite charities;
- ▶ Avoided an immediate capital gains tax of $72,000;
- ▶ Generated new income once the property was sold;
- ▶ Received a substantial charitable income tax deduction in the year of the transfer; and
- ▶ Reduced probate expenses and potential estate taxes by removing the property from their probate estates.

Charitable Lead Trust (CLT)

A charitable lead trust is like a mirror image of the charitable remainder trust. In this gift option, a donor transfers property to the lead trust, which pays a percentage of the value of the trust assets, usually for a term of years, to the charity of the donor's choice. At the end of the trust term, the remaining assets in the trust and any growth it has realized are passed onto the donor or his or her designated beneficiaries. Donors use lead trusts to accomplish the following:

- ▶ Accelerate an income tax charitable deduction for future charitable gifts into the current tax year (qualified grantor lead trust);
- ▶ Pass property to heirs and beneficiaries at reduced transfer tax cost (qualified non-grantor lead trust); and
- ▶ Make charitable gifts beyond the federal income tax charitable deduction ceilings.

There are two types of charitable lead trusts: the *grantor lead trust* and the more popular *non-grantor lead trust*. A grantor lead trust provides the donor with a charitable income tax deduction for the present value of the payments the charity is to receive from the trust. The donor continues to be taxed on the income earned by the trust each year — including the amounts distributed to the charity. At the end of the trust term, the trust assets are returned to the donor or other designated beneficiaries. To avoid any negative tax result, lead trust donors often fund grantor trusts with tax-exempt securities.

In the other type of lead trust, a non-grantor trust, the donor is not treated as the owner and neither reports income earned in the trust nor receives an income tax deduction for the charity's lead interest. The goal of a non-grantor lead trust, however, is not to get an income tax deduction, but to significantly reduce or even eliminate either the gift or estate transfer tax on the value of the assets used to fund the trust. Like the grantor lead trust, at the end of this CLT's term, the assets remaining in the trust are distributed, usually to children or grandchildren. Any appreciation of the value of the trust will avoid gift and estate taxes (transfer taxes) when the assets are eventually received by beneficiaries.

A CLT, either a grantor or non-grantor variety, is not for everyone. They require extensive tax and legal expertise and usually benefit those with serious gift and estate tax considerations. A CLT can be a terrific option if a donor has an income-producing asset that has or will increase in value over time, the donor does not need the income from the asset, and the donor wants the asset back eventually. Here are some of the CLT advantages:

- ▶ The donor receives a gift and estate tax deduction for the assets transferred to the trust (qualified grantor lead trust).
- ▶ CLT property can be transferred to the ultimate beneficiaries at a low transfer cost.
- ▶ Appreciation of the value of the trust will avoid gift and estate taxes (transfer taxes) when eventually received by the beneficiary (non-grantor lead trust).
- ▶ Management of transferred assets can be carried out by an institutional trustee, such as a bank or trust department.
- ▶ It is the best option if the donor has a moderate to large taxable estate.
- ▶ The trust will hold assets with growth and income potential outside of the donor's estate.
- ▶ The donor desires to pass certain assets to heirs or keep them in his or her estate, but also has charitable intent and wants to benefit his or her favorite charity.

Retained Life Estate Deed: Personal Residence or Farm

You can donate your personal residence, farm, or vacation home to the charity of your choice while retaining the right to live on and use the property for life or for a fixed term of years. This arrangement is called a retained life estate. In exchange for this type of planned gift, you receive an immediate income tax deduction. The amount of the deduction depends on the value of the property and your age as well as the age of any other person given lifetime use. You retain the right to rent your home or make improvements to it, and you continue to have responsibility for maintenance, insurance, and property taxes. The advantages of this type of planned gift could be attractive for a donor who does not plan to leave the property to his or her heirs or has no heirs, who has taxable income and could benefit from a charitable deduction, and who wants to benefit his or her favorite charity. Here is a list of the benefits of making a retained life estate gift:

- ▶ The donor receives an immediate income tax deduction for the value of the property minus the present value of the retained life estate.
- ▶ The donor retains full use of the property during his or her lifetime.
- ▶ The donor can reduce gift and estate taxes that would be owed by his or her heirs by removing assets from his or her probate estate.
- ▶ The donor can make a gift now, while retaining the right to use the realty.
- ▶ The donor can benefit a charity of his or her choice.

Obviously, this type of gift will work best for donors who have no plans or desire to pass their residence, farm, or vacation home to their heirs or who have no heirs to whom they wish to leave the property.

Here's an example of how a retained life estate gift works. Ellen, aged 65, a widow, deeds her home to XYZ Charity, though she plans to live there for the rest of her life. The market value of the property is $200,000 (the house, $160,000, and the land, $40,000). Using the required IRS table to discount the gift based on Ellen's life expectancy and future depreciation of the house, her accountant determines her income tax deduction to be in excess of $70,000, which she can take the year of her gift, plus she can carry over any excess deduction

over an additional five tax years. Ellen remains on the property until her death or she moves, retains most incidents of ownership, removes her home from her estate (and thus negates the need for her heirs to use probate proceedings to transfer the deed), and makes a substantial future gift of her home to charity.

Gifts of Life Insurance Policies

Gifting life insurance policies can be another way to make charitable gifts and to potentially achieve income tax deductions. Gifts of life insurance policies can be made by naming a charitable organization as the beneficiary of a life insurance policy, resulting in a charitable estate tax deduction upon the donor's death. Another way to gift a life insurance policy is to irrevocably transfer ownership of the life insurance policy to the charitable organization, resulting in a current income tax deduction at the present value of the policy. Gifting the ownership of the life insurance policy can also provide annual income tax deductions for policy premiums paid by the donor after the gift is made.

A gift of an old, small life insurance policy can result in a much larger gift to charity than a senior might otherwise be able to afford.

18-4. Conclusion

Hopefully, this chapter has enticed you to think about your giving nature and brought about such questions as: Do I want to give to charity? Can I afford to give? How much should I give? Is my charity worthy of a gift? What about my heirs? In the event that you have come to a "Heart and Head" conclusion that charitable giving, especially the gift of a legacy, is something you would like to pursue, the options that gift planning provide are numerous. Although by no means a complete explanation or listing of all the varieties of planned gifts, we provide here a starting point we hope you will find helpful.

18-5. Resources

In today's society, there are more complexities than Thomas Jefferson could ever have anticipated. Fortunately, modern technology gives us an opportunity to evaluate charitable organizations through a variety of resources. Some of those resources are listed here for your convenience:

Charity Navigator
Charity Navigator, America's premier independent charity evaluator, works to advance a more efficient and responsive philanthropic marketplace by evaluating the financial health of over 5,300 of America's largest charities.
www.charitynavigator.org

U.S. National Better Business Bureau
A project of the BBB Wise Giving Alliance, give.org evaluates charities based on financial and management practices. This is the only major site that names charities that do not meet standards.
www.give.org

JustGiving Guide
JustGiving maintains a database of screened and approved charities, organized by subject. A good choice for donors more interested in giving to a particular cause rather than a particular charity.
www.justgive.org

American Institute of Philanthropy Charity Watch
This website provides names and ratings for top-rated charities only. Lesser-rated organizations can be found in their print publication, "Charity Rating Guide."
www.charitywatch.org/toprated.html

GuideStar
The idea here is to provide enough information for donors to make their own judgments. The database includes all IRS-registered tax-deductible charities, comprising over 700,000 organizations. Some listings do not provide full data. You can find interesting information on this site, such as charity CEO and director salaries.
www.guidestar.org

American Red Cross
For over 130 years, Red Cross volunteers have been guided by a single principle: to help people in need, regardless of race, religion, gender, or national origin. The Red Cross has been there, and will continue to be there, for disaster victims in need of food, clothing, and shelter.
www.redcross.org

Network for Good
Network for Good is an e-philanthropy site where individuals can donate, volunteer, and get involved with the issues they care about.
www.networkforgood.org

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The Office of Gift Planning at CSU cultivates, designs, facilitates, and stewards planned gifts to the University, and works with donors who contribute non-cash gifts (appreciated stocks, real estate, etc.). In our efforts, we use a variety of financial tools and techniques for giving, including bequests, charitable gift annuities, charitable remainder trusts, and charitable lead trusts. All planned gifts require the assistance of one or more qualified specialists: an attorney, certified public accountant, estate planning specialist, trust officer, and/or an insurance agent can be involved as we work with donors to accomplish their charitable goals.

In addition, we provide education to our donors through marketing and outreach efforts that include advertisements, publications, brochures, website information, e-newsletters, public speaking presentations, and the like. We consider it absolutely essential to make our office a resource for folks who are contemplating a deferred gift or have any questions concerning their estate planning goals. Additionally, we supply technical expertise to our colleagues in the development staff and work closely with them if they have a donor who is considering a planned gift.