The Wealth Counselor

A monthly newsletter for wealth planning professionals

From
Brown & Streza LLP
40 Pacifica
Suite 1500
Irvine, CA 92618
949-453-2900

Brown & Streza LLP
Estate Planning -
Business Planning -
Income Tax Planning -
Charitable Sector -
Mergers & Acquisitions

Volume 7, Issue 11

Uncovering Charitable Planning Opportunities

Charitable giving is discretionary spending. It is affected by both the economy and the income tax rates. Not surprisingly, charitable giving has been down in recent years, but this does not mean clients are less charitably inclined. Many just need to be pointed in the right direction. With the $5.12 million transfer tax exemption ending on December 31st and higher income tax rates looming for 2013, now is an excellent time to begin discussing charitable planning solutions.

Choice of a charitable planning technique is mostly driven by the type of client and asset involved. Therefore, in this issue of *The Wealth Counselor*, we will focus on the *types* of clients who might benefit from charitable planning and for each the kinds of charitable planning that can work for them, and some pitfalls to avoid.

Charitable planning is most beneficial to those clients who already have some interest in charity or have other non-tax reasons for doing charitable planning.

Client Category: Young Professionals
These clients are usually still building their assets and may have some outstanding student loans and probably have mortgage debt. Their current estate planning goals are more likely to be centered on taking care of a surviving spouse and minor children, but they may still like to benefit their favorite charities (a college or church, for example) if they were to pass away unexpectedly. For these busy professionals, simple is usually best. Flexibility is also important because their estate plan will need to change several times over their lifetimes.

For these reasons, a simple bequest in a will or trust may be the solution. It's not complicated, it's revocable, and it can be drafted to take effect after the death of the second spouse.

> ***Planning Tip:*** If there will be significant restrictions on the gift, the client should talk to their charity first and make sure the gift will be acceptable. For example, some charities have minimum requirements on gifts to be used for specific purposes.

Tax Issues
Assuming the beneficiary is a qualified domestic or foreign charity, the bequest should generate an estate tax charitable deduction. Note the difference with income tax deductions, which do not apply to gifts to foreign charities. Gifts to certain ESOPs and to fraternal benefit organizations (lodges) can qualify for the estate tax charitable deduction, but those to sororities and fraternities usually do not.

Client Category: Has a Large IRA or Retirement Plan Account
Doctors, business executives and other clients may have large IRAs, sometimes with few other liquid assets. The problem is that, because of the combined effects of income and estate taxes, dying while owning a large IRA can create a large tax liability—with as much as 70% of the IRA going to taxes. For clients with large IRAs, especially those who are not married, charitable IRA planning is often very attractive.

Potential strategies include:
1) Naming a qualified charity as the beneficiary of all or part of the IRA. This is easily accomplished by naming the charity as a beneficiary on a beneficiary designation form obtained from the IRA administer. The designation should be revocable to preserve flexibility.

2) If it comes back, taking advantage of the Charitable IRA Rollover. The Charitable IRA Rollover opportunity ended on December 31, 2011. However, there is a chance that it might be extended retroactively through December 31, 2013. (Such an extension is part of the proposed Family and Business Tax Cut Certainty Act of 2012, which passed the Senate Finance Committee on August 2, 2012.) Stay tuned for post-election developments.

The Charitable IRA Rollover allowed up to $100,000 to be paid by the IRA administrator to a qualified charity if the IRA owner had attained age 70 ½. Distributions counted toward the individual's annual mandatory IRA withdrawal amount but were not included in the IRA owner's taxable income.

Tax Issues

Funds held at the time of death in an IRA, 401(k), 403(b) or other deferred income account are called, in tax jargon, "income in respect of a decedent" or "IRD." IRD includes all amounts earned during the decedent's lifetime that have not yet been subject to income tax. Code Section 691 states that a recipient of IRD is treated as the recipient of the income and so must pay income tax on it.

Because a charity is tax-exempt, it can receive items of IRD without paying income tax on those items. Also, because the donor receives an estate tax deduction for the gift, IRD assets passing to a charity are unreduced by estate taxes.

By comparison, if IRD is inherited by an individual, that beneficiary would pay state and local income taxes on the IRD and the decedent's estate would be liable for any state and Federal estate taxes.

Client Category: Has Low Basis Assets

Many clients have stocks and other investments with a low cost basis that they have held onto for a very long time. Low basis assets can also exist with younger clients, for example those who were involved in successful start-ups. This client may want to make a larger gift to a charity—endow a chair at their alma mater, set up a scholarship fund, or help to renovate their church—but needs an income stream. Charitable planning can minimize the client's capital gain burden while monetizing the asset to provide the income stream.

Two strategies that will extend the recognition of gain over time are:
1) Charitable Gift Annuity (CGA). With a CGA, the donor transfers an asset or assets to a charity in return for the charity's issuing an annuity contract to the donor. To the extent that this annuity does not provide the same value of benefit that a commercial annuity would provide; the difference is a gift to the charity. If the annuity is exchanged for appreciated property, it may be possible to recognize the gain on the transaction over the life of the annuity.

With a CGA, the donor receives a current deduction for the charitable portion of the transaction. The annuity payments continue for the agreed term, which may be the life of the donor(s). With a life annuity, the cumulative amount of the annuity paid may be more or less than the value of the original property transferred; depending on whether the donor(s) die prematurely or later than an actuary would predict. The annuity payment is a general debt of the charity so it is important to work with a charity that is credit worthy. Administrative costs are low, so a CGA can be done for fairly small amounts as long as the charity is willing.

> ***Planning Tip****:* State law may limit the ability to use real estate or other very illiquid assets to purchase the CGA.

2) Charitable Remainder Trust (CRT). As with the CGA, the donor transfers appreciated property and receives a stream of payments over a defined term. With a CRT, the CRT Trustee sells the assets and pays the donor an annuity or "unitrust" amount (a set percentage of the fair market value of the trust's assets revalued annually), depending on the terms of the CRT. Capital gain is recognized as the donor receives the annuity/ unitrust payment. At the end of the trust term, the designated charity receives whatever is left in the trust. If the principal of the trust is exhausted in the payment of the annuity or unitrust amount to the donor, the income stream stops and the charity gets nothing.

Upon creation of the CRT, the donor receives a charitable income tax deduction for the actuarial present value of that remainder interest in the trust.

A CRT can benefit any charity, and is generally not limited in the type or amount of assets that can be used (with a general exception that a CRT should not hold an asset that produces unrelated business taxable income, such as S Corporation shares). Because a CRT is a separate, private trust, administrative costs are higher than is typical with a CGA, so a CRT is more often used for larger donation amounts.

> ***Planning Tip****:* Current low interest rates used in the residual interest valuation (1.2% for November) disfavor the use of the CRT.

Note that neither the CGA nor the CRT erases the capital gain from the disposition of the appreciated asset. Instead, both defer the recognition of the gain over the life of the annuity or unitrust payment. As a result, some gain may not be recognized until the death of the donor if the annuity or unitrust is for life. Also, depending on the transaction structure, the donor may be able to plan the timing of some income.

Client Category: Has Income Producing Assets

This client may have equity in a small business or real estate that is producing a good amount of income. He does not want to permanently part with the asset and wants for it ultimately to go to his children. A Charitable Lead Trust (CLT) can be the answer for the charitably inclined client. A CLT can be designed to give an income stream to a charity, reduce the client's estate and gift tax bill and preserve the asset for future generations.

A CLT is almost the opposite of a CRT. During the term of the CLT, the trust pays an annuity or unitrust amount to the charity. At the end of the trust's term, the remaining assets can return to the donor or, more commonly, pass to family members. If the assets in the trust grow at a rate that is greater than the actuarial rate of growth, all of that appreciation passes free from estate or gift tax.

> ***Planning Tip:*** In a low interest rate environment, when the government assumes a very low rate of actuarial growth, it is much easier for the CLT to outperform these assumptions and pass appreciation tax-free to the donor's children or other beneficiaries.

Tax Issues

A CLT is a private trust and is subject to normal rules for the income taxation of trusts. A CLT can be a grantor or a non-grantor trust.

If the CLT is a grantor trust, the donor will receive an income tax deduction in the year of the CLT's funding that is equal to the actuarial value of the income interest passing to the charity. But if the remainder beneficiary is a trust, the necessary generation skipping transfer (GST) tax allocation will not be determined until the trust term ends. On the other hand, if the CLT is not a grantor trust, the donor does not receive an income tax deduction on creation of the trust, but the trust will take a charitable deduction every year for the amount that it pays out to charity. The GST tax allocation amount is determined on the creation of the trust.

> ***Planning Tip:*** A grantor CLT can be advantageous for a client who needs large up-front deductions in a year in which the donor has a significant income.

Client Category: Small Business Owner or High Net Worth

These clients have worked hard to build their wealth and they often want to leave a legacy for future generations. They like to be in control, but do not like to be bothered with a lot of details and definitely do not want the next generation to fail when they receive the family's wealth. Proper use of a charitable component to wealth planning can greatly increase the probability that the next generation will preserve the legacy while balancing control issues and administrative complexity.

Worldwide and over recorded history, successful intergenerational wealth transfer has been difficult to achieve. It fails in about 70% of the cases. Family philanthropic activities have proven to be a very effective vehicle for training the next generation to manage and appreciate their family's wealth. In addition to training the next generation, the donor's name can be kept alive for an indefinite period. Did you ever notice all those donor names that stream by at the beginning or end of shows on PBS? They are the names of people who have used these charity strategies.

Two charity strategies that can help these clients leave a legacy are:

1) Donor Advised Fund (DAF). Under this arrangement, the donor gives assets to a charity that sponsors DAFs, such as a community foundation. The assets are held and managed by the charity in a separate account that is governed by a fund agreement that states how much of the assets in the DAF may be distributed each year (usually a percentage, typically 4%). The fund agreement also specifies who will have the opportunity to suggest to what charities, for what purpose, and in what amounts the distributions will be made. While the assets belong to the charity and the donor only has the ability to recommend distributions, most DAF-holding charities will honor the donor's or other designated directing person's wishes because it knows that unreasonable failure to do so would quickly become common knowledge and end its receipt of future donations. The DAF-holding charity usually charges an administrative fee (typically 1% per year) against the DAF assets. Typically, the DAF can continue beyond the life of the donor, and family members can hold recommendation powers. The rules will vary by DAF-holding charity.

2) Private Foundation. The private foundation is a separate entity with its own governing body, bylaws, tax return, bank account, EIN, etc. It offers the most control by the donor, but that control comes at a price. The private foundation is administratively complicated; the income tax deduction available for gifts to private foundations is more limited than that for gifts to other types of charities. A private foundation is also subject to limits on its investments, the manner in which grants can be made, is required to pay out at least 5% of its assets annually in grants and qualifying expenses, and most transactions between the foundation, its founder, the members of its governing body and their families/related entities are prohibited. The excise taxes that are imposed for violations are extremely punitive. Because of the administrative costs, a private foundation holding less than $2 million in assets is probably not feasible.

> ***Planning Tip:*** To get the benefit of the training opportunities that family philanthropy affords, the donor and the donor's family members should meet both during the donor's lifetime and after his or her death. The meetings should be open discussions in order to plan for the operation and ongoing administration of the DAF or private foundation. Otherwise, family members' conflicting views, lack of time and/or lack of interest will cause problems after the donor's death both for the family's wealth and the family's philanthropic activities.

Client Category: Land Owner

This client may have farmland, ranch land or land that is prime for development. The client may have family members that will take over the land after his or her death, but the client may be the last generation to actively operate the farm or ranch and is looking for other ideas to protect the land or pass on its value. It is critical to understand what the donor needs and when, in order to determine the proper planning option: for example, if he will continue to live on or work the property, if he needs cash flow, and if he needs a current or future tax deduction.

Charitable planning for the land owner may include:

1) Giving a charity a remainder interest in a farm, ranch or personal residence. This allows the client to live on and/or work the property during his or her lifetime and take a current income tax deduction for the current actuarial value of the remainder interest.

2) Giving a charity a fractional interest in land. This, too, provides a current income tax deduction for the fair market value of the interest donated to the charity. This technique is most often used with land that is not producing income.

3) Giving a charity a "qualified conservation easement," whereby the land is burdened by some limitation on its development and is given the right of enforcement of the limitation. This gift, too, can qualify for a current income tax deduction if made during the donor's life or an estate tax deduction if made at or after the donor's death. Often a charity will not accept a qualified conservation easement without a simultaneous gift of money to fund the continual enforcement of the restriction over time. Qualified conservation easements are extremely technical and require great care to document and value.

FLIP-CRUT

For the landowner who needs an income stream from appreciated real property, a FLIP-CRUT (a specific type of Charitable Remainder Trust) may be appropriate. Under a FLIP-CRUT agreement, the donor transfers the land to the trust and, per the terms of the trust, pays the donor the income from the property prior to its sale and, following the sale, "flips" to paying a flat unitrust amount (e.g., 5% of the trust assets, valued annually). The amount paid to the donor from the unitrust changes with the value of the investments in the trust. The gain on the real estate is deferred over time with the donor recognizing gain annually as the unitrust amount is paid out. In the year the FLIP -CRUT is established, the donor receives an income tax deduction for the current value of the charitable component of the transaction.

Client Category: Collector

This is a client who has spent considerable time, effort and money over the years purchasing, housing and protecting something—art, antiques, cars, rare books, musical instruments, etc.—that means a great deal to him or her. A charity can help. An outright gift is the simplest opportunity, although it involves loss of possession to the public. However, through a structured gift to charity the collector may be able, for a while, to continue to enjoy the collection while mitigating the burden of housing and administering it.

The possibilities include:

1. Outright gift to a public charity for related use. If the donor gives tangible property to a public charity to be used by the charity in a way that is related to its mission, the donor's income tax deduction is equal to the fair market value of the property reduced by any built-in short-term capital gain. If the donor gives the property to a private foundation or to an organization that will not use it for a related use, the donor's deduction is generally limited to the donor's basis in the property.

2. Fractional interest gift. The donor can give a fractional interest in an item or a collection (for example, giving a museum a one-half undivided interest as a tenant-in common). An arrangement like this would allow the donor and the museum to split the time each has possession of the collection. The IRS will allow a current deduction of the value of the fractional interest transferred if the charity obtains all of the interests in the property within earlier period of not more than ten years or on the donor's death, if that occurs earlier.

The agreement with the charity must address its partial ownership of the property and arrangements for storage, transportation, display, insurance, conservation, etc.

> ***Planning Tip:*** It is essential for someone to first talk to the charity and make sure it will accept the gift, especially if the donor desires to impose any restrictions on its use.

Conclusion

Charitable planning techniques are not "one size fits all." Let the client's assets, desires and needs lead to the technique(s) that might be appropriate. Advisors who are aware of these types of clients and charitable planning solutions that might work for them will prove very valuable to both their clients and the other advisory team members.