Tax Economics of Charitable Giving

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What We Will Cover

- The elements of a charitable deduction
- Income tax and tax brackets
- AGI limits and deduction amounts
- Value of deductions – typical donations
- Documentation requirements
- Income tax benefit of a charitable deduction
- IRA qualified charitable rollover
- Transfer taxes
- Traditional philanthropic vehicles
- Charitable vehicles that provide income
- Top charitable planning strategies

Elements of a Charitable Deduction

- Must be a completed gift of cash or other property (certain exceptions)
- Gift must be delivered before the end of the year
- Gift must be unconditional and without personal benefit to the donor. Donation could have been given for a restricted purpose however
- Gift must be made “to or for the use of” a charity
- Deduction cannot be in excess of amount allowed by law
- Gift must have prescribed substantiation

Income Tax and Tax Brackets

Calculating Income Tax – (a review)

Gross Income

- Everything earned or received as taxable income during the year

Minus Adjustments

- Such as self-employed health insurance, alimony payments, IRA contributions

Equals Adjusted Gross Income

Minus Personal Exemptions

- $4,050 per dependent for 2017

Income Tax and Tax Brackets (Continued)

Minus Deductions

- Standard deduction of $6,350 for single, $12,700 for married filing joint, or itemized deductions (including charitable), if greater than standard deduction

Equals Taxable Income

Federal Tax Brackets for 2017

- *Married Individuals Filing Joint Returns and Surviving Spouses as an example*

Taxable Income	*Tax Due*
$0 - $18,650	*10%*
$18,651 - $75,900	*$1,865 plus 15% over $18,650*
$75,901 - $153,100	*$10,452 plus 25% over $ 75,900*

Tax Brackets (Continued)

Taxable Income	*Tax Due*
$153,101 - $223,350	$29,753 plus 28% over $ 153,100
$233,351 - $416,700	$52,222 plus 33% over $233,350
$416,701 - $470,700	$112,728 plus 35% over $416,700
$470,701 plus	$131,628 plus 39.6% over $470,700

Charitable Deductions (Continued)

- Introducing the concept of the capital gains tax as it affects the charitable deduction
- A Capital Asset is distinguished from ordinary income property in that it is generally an investment such as stocks, bonds or real estate
- A capital gain is the sales price of an asset over its cost basis (reduced by depreciation, if applicable)

Charitable Deductions (Continued)

- The capital gains tax rate applied to qualified dividends and gain from the sale of capital assets held more than one year is lower than the rate on ordinary income such as wages. Gain from short-term capital gain (held less than a year) is taxed at ordinary income rates.
- The long-term capital gains rate is also graduated, topping out at 20% if a taxpayer is in the top 39.6% ordinary income tax bracket (AGI over $470,700).

Charitable Deductions (Continued)

- In addition to the ordinary income tax and the capital gains tax, there is now a net investment income ("NII") tax of 3.8%, which is applied to NII – including capital gains, for filers with NII above certain income thresholds ($250,000 for married filing joint)
- Therefore, you may see the top capital gains rate referred to as 23.8%
- In addition, there is a alternative minimum tax (AMT) system that a taxpayer would pay at 28%. You literally calculate your income tax twice under regular tax and AMT and pay the higher amount.
- Although complicated, taxpayers most likely subject to AMT are those with high state and local income taxes
- There are also state taxes to be considered

AGI Limits and Deduction Amounts

Adjusted Gross Income Limitations for Individuals

Type of Property Donated	Type of Charity	
	50% Charity [a]	30% Charity [b]
	AGI Limitations	
Cash	50%	30%
Ordinary Income Property	50% [c]	30% [c]
Long-term Capital Gain Property	30% [d]	20% [e]
Tangible Property Unrelated to Tax-exempt Use	50% [c]	30% [c]

a. Publicly supported charities: The most common 50% charities include churches, schools, hospitals, governmental entities, private operating foundations and other nonprofit agencies organized for charitable, religious, educational, scientific, or literary purposes.

b. Common charities in this group include veterans organization, domestic fraternal societies, nonprofit cemeteries, and certain private foundations.

c. Deduction before AGI limit is limited to the lesser of FMV or cost basis.

d. Donor may elect to deduct cost basis rather than FMV, in which case the AGI limits are the same as cash contributions.

e. Deduction is limited to cost basis unless securities are public traded.

Value of Deduction – Typical Donations

Type of property	*Amount deductible*
• Cash	Amount given
• Short-term gain property (less than one year)	Cost or adjusted basis
• Long-term gain (more than one year); related use personal property	Fair Market Value
• Tangible personal property for unrelated use	Cost or adjusted basis
• Gifts to private non-operating foundations	Cost or adjusted basis fair market value for qualified appreciated stock

Substantiation (Documentation Requirements)

- To get a charitable deduction for income tax purposes, gifts over $250 must be documented in writing from the charity as to - who made the gift?, what was the gift?, when was the gift made?, and to whom was the gift given?

- The written documentation must also state that the donor did not receive any goods or services in return for the gift (or alternatively, the value of such goods or services)

- Certain large property gifts require appraisals to show how the gift was valued - $5,000 and up

Substantiation (Continued)

- Distinctions exist for gifts of cash whether below $250 or above $250

- Gifts of property over $500 requires a separate IRS form with the donor's tax return
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- Gifts of property above $5,000 require a qualified appraisal of the property and a summary included with the return

- Gifts of property over $500,000 and gifts of art over $20,000 require the entire qualified appraisal with the return

Traditional Philanthropic Vehicles

- Public Charity
- Private Non-Operating Foundation
- Private Operating Foundation
- Donor Advised Funds
- Supporting Organization

Factors to Consider

- Desired Level of Control of Creator
- Desired Level of Participation by Creator
- Potential for Involvement of Future Generations
- Amount of Initial Funding
- Amount of Ongoing Funding
- Sources of Funding
- Beneficiaries to be Served
- Social Impact to be Achieved

Publicly Supported Charity – Overview

- Operate Exclusively for Charitable, Religious, Scientific, or Educational Purposes
- Meet Section 509(a)(1) or 509(a)(2) Public Support Test
  - Minimum of 1/3 of support must come from the general public or government sources - 509(a)(1)
    - Alternative 10% facts-and-circumstances test
  - Minimum of 1/3 of support must come from contributions, membership fees, and gross receipts from exempt activities; and <u>no more than</u> 1/3 of support from gross investment income and unrelated business income - 509(a)(2)

Pros and Cons – Publicly Supported Charity

Pros

- Maximum deductibility of contributions
- Identification of contributors generally not subject to public disclosure
- Not subject to private foundation excise taxes
- Small organizations may file Form 990-N

Cons

- Must maintain broad public support
- General 501 (c)(3) restrictions on private inurement, private benefit, limitations on lobbying, prohibition on political activity
- Costly to establish and maintain properly
- Potential excise tax on excess benefit transactions

Private Foundation - Overview

- Can be Funded by Individual or Family or Others
- Public Support Test does not Apply
- Excise Tax Regime

Code Section

4940: Investment Income

4941: Self-Dealing

4942: Failure to Distribute Income

4943: Excess Business Holdings

4944: Investment that Jeopardize Charitable Purpose

4945: Taxable Expenditures

Pros and Cons – Private Foundation

Pros

- Control and funding can be with an individual or a family
- Facilitate strategic goals for charitable giving
- Establish a legacy of giving
- Current tax deduction for future grants

Cons

- Reduced deductibility limit on contributions
- Subject to complex excise tax regime
- Minimum distribution requirement
- Costly to establish and maintain

Private Operating Foundation – Overview

- Generally, a private foundation that devotes most of its resources to the active conduct of exempt activities

- Must meet income test and one of the following:
  - Assets test
  - Endowment test
  - Support test

Pros and Cons – Private Operating Foundation

Pros

- Maximum deductibility of contributions
- Not subject to excise tax on failure to distribute income
- May receive qualifying distributions from other private foundations

Cons

- Subject to the tax on net investment income and other private foundation restrictions
- Complex tests to met in order to qualify
- Costly to establish and maintain

Donor Advised Funds - Overview

- Generally, a separately identified fund or account that is maintained and operated by a section 501(c)(3) organization ("sponsoring organization")
- Sponsoring organization has legal control over the funds
- Donor retains advisory privileges with respect to the distribution of funds and the investment of assets
- Some allow donation of non-cash assets

Pros and Cons - Donor-Advised Fund

Pros

- Maximum deductibility of contributions
- Streamlined recordkeeping and compliance
- Minimal costs to establish
- No minimum distribution requirement

Cons

- Control versus "advice"
- Potential hidden fees
- Grantee must be a public charity
  Funds may be "parked" rather than distributed to charitable beneficiaries
- Excise Taxes for taxable distributions or more incidental benefits
- Potential denial of deduction

Supporting Organization • Overview

- Must be organized exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more 509(a)(1) or (2) organizations
- Three "types":
  - Type I- parent/subsidiary relationship
  - Type II - brother/sister relationship
  - Type III - less control by supported organization(s)
    - Functionally-integrated
    - Non-functionally-integrated

Supporting Organization – Overview (continued)

- Type III- less control by supported organization(s)
  - Notification requirement
  - Responsiveness test
  - Integral part test
    - Functionally-integrated supporting organizations must meet one of three alternative integral part tests (activities test, parent of supported organizations, or supporting a governmental entity)
    - Non-functionally-integrated supporting organizations must distribute a "distributable amount" each year; sufficient to ensure attentiveness

Pros and Cons – Supporting Organization

Pros

- Public support test does not apply
- Maximum deductibility of contributions
- Can provide some autonomy to a fundraising organization for a particular charity

Cons

- Expanded Schedule A reporting
- Complex tests to meet
- Costly to establish and maintain

Income Tax Benefit of a Charitable Deduction

- A donor’s economic cost in making a gift is reduced by the tax savings which depends on their marginal tax bracket

- For example, a gift of $10,000 for a donor in a 40% marginal tax bracket would be a cost of $6,000 – ($10,000, less tax savings of $4,000)

- Cost of a gift of a long term appreciated stock may be lower than the cost if the donor sells the stock and contributes the after-tax sales proceeds

Income Tax Benefit of a Charitable Deduction (Continued)

- For example, a gift of Apple stock worth $10,000 with a tax basis of $2,000 would cost a 40% bracket donor $6,000 ($10,000 value, less $4,000 tax savings). If the stock was sold by the donor, with the donor gifting $10,000 of cash, the cost of the gift would be increased by the capital gains tax: $8,000 x 23.8% = $1,904

Income Tax Benefit of a Charitable Deduction (Continued)

- A charitable deduction may be reduced by the so-called phase-out of itemized deductions

- Itemized deductions generally including charitable deductions, are reduced for high income taxpayers by 3% of AGI above a threshold (incomes above $313,800 for married filing joint)

- Exemptions are also phased-out above certain income levels. Exemptions phase out completely over $436,300 for married filing joint.

Transfer Taxes

- For transfer taxes (i.e. estate and a gift taxes) there is an unlimited charitable deduction

- Several basic concepts – 40% tax rate (Federal); annual exclusion for gifts of $14,000 per year ($28,000 for a married couple); Lifetime exemption of $5.49 million for 2017 which could therefore mean $10.98 million exemption for a married couple

- Spousal marital deduction of an unlimited amount and unlimited deduction for charitable contributions

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IRA Qualified Charitable Rollover

- Been around since 2006 and is now a permanent part of the law

- Individuals age 70½ or older can distribute up to $100,000 from their IRA's directly to qualified charities without having to include the distribution in their gross income

IRA Qualified Charitable Rollover (Continued)

- The amount distributed is not included in the AGI of the donor, thereby not impacting deductions that are affected by AGI limits

- Donations must go directly from IRA custodian to a public charity

- The amount so distributed to charity qualifies as “required minimum distributions” under the IRA rules

Charitable Vehicles Providing an Income

- **Charitable Gift Annuities**
- **Charitable Remainder Trust**

<u>Charitable Gift Annuities</u>

- A contract between an individual and a qualified charitable organization whereby a gift of cash or other property to the charity is made in exchange for a fixed and guaranteed income stream for the life of the individual or for the joint lives of the individual and a named beneficiary (usually the spouse)
- The purchase of a gift annuity
  - Provides a fixed income stream for the annuity period
  - Makes a gift to the charitable organization
- Usually about 50% a gift and 50% a contribution
- Can be purchased in small amounts like $10,000

Charitable Vehicles Providing an Income

Charitable Remainder Trust (CRT)

- The CRT provides a unique opportunity for a donor to retain lifetime income from property while obtaining a current income or estate tax deduction for the remainder interest that eventually will pass to charity
- Property (cash or appreciated assets) are transferred to a CRT which is an exempt entity not paying tax (creates a special planning opportunity for transfer or appreciated assets)
- Trust pays out a special amount each year to named beneficiaries
- Upon death of final beneficiary or upon a set term, remaining amounts in trust transfer to named charity(ies)
- A powerful and flexible tool for those contemplating a substantial gift to charity

Top Charitable Planning Strategies

- Borrowed from Russell James , JD, PhD Texas Tech

1. Never Give Cash – Gifts of Appreciated assets usually yield a better tax return. Requires the donor to have appreciated assets that would yield a fair market value tax deduction. Taxpayers who make cash gifts and report capital gains often did not get the best tax result.

Top Charitable Planning Strategies

2. Give retirement RMD first and more at death. After age 70½ participants in a IRA must take a required minimum distribution or pay a steep penalty. IRA charitable rollover allows up to a $100,000 IRA charitable rollover meeting the RMD requirement eliminating both the income and deduction.

   In addition retirement plan assets inherited by non-charitable beneficiaries are reduced by income tax. Other assets are best left to heirs and retirement plan assets to charity upon demise. Retirement plan charitable beneficiaries could be a public charity, private family foundation or a charitable remainder trust.

Top Charitable Planning Strategies

3. Take deductions today for transfers tomorrow – A remainder interest in a home or farm gives the right to own the property after a set time or after the death of a person. Low Section 7520 Rate means a higher deduction for remainder interest deed in home or farmland.

   Charitable remainder trust – generates an immediate income tax deduction, even though donor can manage assets and receive income for life.

Top Charitable Planning Strategies

4. Match deductions with Roth conversions – Roth conversions and charitable planning can work together to match income and deductions. Offsetting charitable deductions through a charitable remainder trust, grantor charitable lead trust, charitable gift annuity, donor advised fund or a private foundation or give a remainder interest in a residence or farmland. Beware of AGI deduction limits.

Top Charitable Planning Strategies

5. Buy life insurance with new tax deductions. Charitable planning devices produce great tax advantages but they also reduce an heir's inheritance. An irrevocable life insurance trust could be done using tax savings to fund insurance premiums and allow some amounts to be transferred to heirs estate tax free.

Top Charitable Planning Strategies

6. Earn more income by avoiding capital gains tax. Converting a highly appreciated asset that generates little income (like developable land or a non-dividend paying stock). Transfer the asset to a charitable remainder trust and earn income for life on the full amount (not reduced by capital gains tax).

Top Charitable Planning Strategies

7. Advanced charitable strategies to preserve wealth – might benefit your organization indirectly. Lifetime and testamentary transfers to private foundation; CRT (spigot) paying for life (if needed for income) then to family foundation; Zeroed out non-grantor CLT that pays charitable interest to family foundation, excess growth to children; Multi-generational testamentary CRT, income to kids, then to private foundation run by grandchildren.

Top Charitable Planning Strategies

8. Tax-free growth environments – Growth inside a donor-advised fund, a charitable remainder trust (only distributions are taxed), growth inside a private foundation is limited as to tax.

Top Charitable Planning Strategies

9. Research has indicated, charitable estate donors grew their estates faster than did others with same initial wealth.

Top Charitable Planning Strategies

10. Increases in charitable planning are driven by increases in childlessness and education. Both of these should increase in the coming decades.