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THE Good Advisor

Planned Giving in Difficult Economic Times

In difficult economic times, people tend to tighten their financial belts. In fall 2008, the individual savings rate increased to its highest level since 2002 in response to the bad economic news. Today, a sense of thrift and sacrifice has become paramount in personal financial planning.

Lower personal spending and reduced household budgets have had an impact on individual charitable giving. The Center on Philanthropy at Indiana University published its Briefing on the Economy and Charitable Giving in December 2008. The authors linked charitable giving trends to economic indicators such as the GDP, the S&P 500 and reported individual income. In predicting the level of charitable giving at this time, the authors noted that the amount of giving can decline in periods of recession and can decline considerably in long recessions.

However, the authors also noted that most households continue to give during times of financial insecurity. The desire to help and support favorite charities remains strong. And, it is especially true that charities need this help and support today more than in other years.

In this newsletter, we discuss different options for planned giving in difficult economic times. There are two types of giving that fit this description:

- Giving at little or no present cost, and
- Giving that could be advantageous in the present down market.

One (or more) of these options may provide a way for your clients to continue their positive philanthropic efforts through lean years.

CHARITABLE LEAD TRUST

One method of charitable giving that has a distinct advantage during an under-performing economy is the charitable lead trust (CLT). A CLT is an irrevocable trust established to pay a charity an annual income consisting of a specified dollar amount or a percentage of trust assets as determined every year. At the end of the trust term (either a term of years or as based on a measuring life), the CLT assets are distributed to non-charitable beneficiaries.

There are two types of qualified CLTs: grantor CLT and non-grantor CLT. The grantor CLT distributes the assets (back) to the grantor at the end of the trust term. The non-grantor CLT distributes the trust assets to family members at the end of the trust term. The advantage of the non-grantor CLT is the enhanced ability to transfer assets to family members (it is often called a "family lead trust").

A primary reason for the viability of non-grantor CLTs is the historically low applicable federal rate (AFR). The AFR is published by the Treasury department every month to value annuities, life interests or interests for terms of years and remainder or reversionary interests. The AFR is important because a low AFR increases the present value of the charity's income interest which reduces the valuation of trust assets expected to go to non-charitable beneficiaries. Moreover, if the trust corpus appreciates during the trust term, the appreciation escapes transfer taxation when it ultimately passes to family members. The AFR for February 2009 was 2.0%.

A second reason for the viability of a non-grantor CLT is the advantage gained by utilizing assets with depressed values. If the grantor believes that the value of the assets in the CLT will improve during the term of the trust, the grantor has the advantage of a lower transfer tax valuation at the time he or she puts the assets into the CLT.

A third and possibly most important advantage is that the CLT benefits the charity immediately with annual payments. As noted, charities are having a difficult time, and the philanthropic boost of the CLT is more direct than a charitable gift annuity or a charitable remainder trust.

CHARITABLE BEQUEST

Bequest giving is the most popular form of planned giving. Donors appreciate the simplicity of naming a worthwhile charity in their will. And, donors continue to utilize the asset during their lifetime. A bequest is a way to memorialize their commitments to charity, so including a charity in estate plans has a strong appeal to many donors. Even though it may be difficult to make a significant gift today, these donors can plan for a very significant gift from their estate.

Nearly any asset can be used to make a charitable bequest, but certain types of property are uniquely appropriate for bequests.

Tangible Personal Property

Tangible personal property (e.g., artwork, collections, antiques, etc.) may be given to a charity by bequest. Bequests of tangible personal property qualify for the estate tax charitable deduction for the current full appraised value without regard to whether the charity puts the property to a "related use" as is required for the income tax charitable deduction.

Ordinary Income Property

Ordinary income property (e.g., artwork owned or a copyright held by the original artist creator) given by bequest is also deductible at the current full appraised value for purposes of the estate tax charitable deduction. The reduction of the deemed amount of the contribution to cost basis required for the income tax charitable deduction does not apply for estate tax purposes.

Depressed Value Property

Since heirs cannot benefit from a step-up in basis with depressed property, property that has experienced a loss in value may be particularly appropriate for a charitable bequest.

Income in Respect of a Decedent

Income in Respect of a Decedent (IRD) is inherited property that would have been taxable income to the decedent if the decedent had received it before death. Common examples of IRD are an IRA that was tax deductible or a qualified plan such as a 401(k) plan where contributions were made on a pretax basis. Since the earnings have never been taxed, IRD is subject to federal income tax. And, if the estate of the decedent is subject to federal estate tax, IRD is an estate asset and is also subject to federal estate tax. Donating IRD assets to a charity through a bequest can both create an estate tax charitable deduction and eliminate the negative income tax component because a qualified charity that receives the IRD assets is exempt from federal income tax. This is a significant tax-saving strategy but can be complex and requires the skill of a knowledgeable tax professional.

CHARITABLE GIFT OF A LIFE INSURANCE POLICY

Charitable gifts of life insurance can enable a donor to substantially increase the potential amount of his or her gift while enjoying attractive tax advantages. Plus, a charitable gift of life insurance is a cost-effective way to make a major planned gift. A donor has three basic choices in planning a gift of life insurance:

Gift of an Existing Policy

A simple, outright gift of an existing life insurance policy can qualify for the income tax charitable deduction. To do so, the donor should assign all rights to charity (naming charity as policyowner and beneficiary). If the donor retains any rights in the policy after the assignment, such as the right to borrow cash values or to change the beneficiary, the result would be a gift of a "partial interest" that would not qualify for the income tax (or gift tax) charitable deduction.

When an individual gives a life insurance policy to charity, the amount of his or her charitable contribution is deemed to be the lesser of:

- The fair market value of the policy, or
- The donor's basis in the policy.

Gift of a New Policy

The donor may apply for a new policy on his or her life, with the charity as the original policyowner and beneficiary. The fair market value of a newly issued policy is the initial premium that was paid to put the policy in force. And a newly issued life insurance policy can substantially leverage the size of a donor's gift. To secure such a policy, funds should be donated to the charity, and the charity should be applicant, owner and beneficiary of the new policy. However, be sure to check state laws regarding insurable interest.

There are two major benefits of making the charity the applicant. The first benefit is that the initial premium amount donated to the charity may be deducted. If the donor had bought the policy and then donated it, the fair market value of the policy on the date of donation would likely be lower than the donor's premium (cost basis), and would permit only the lower deduction.

The second advantage of making the charity the applicant is that, because the donor will never have held any incidents of ownership in the policy, its value will not be included in the donor's gross estate at death.

Naming the Charity as a Beneficiary

If a donor does not desire to make an immediate gift with respect to an existing policy, the donor may retain ownership and control of the policy but name a charity as beneficiary for part or all of the death benefit. This will not produce any income tax charitable deduction at the time the beneficiary designation is made, but it will result in an estate tax charitable deduction for the death proceeds passing to the charity at the insured donor's death.

A TWO-PART APPROACH: SELL A DEPRECIATED ASSET AND DONATE THE PROCEEDS TO CHARITY

A charitable gift of depreciated stock is not a good choice. The stock has lost value and the donor who gives a depreciated stock to charity has a deduction for the fair market value of the stock, not the original price paid for the stock. However, an individual can deduct investment losses, so he or she could sell the stock and deduct the loss. Then the individual could donate the proceeds from the sale of the stock to a charity.

Normally, the time that donors utilize this planning approach – combining a sale of a depreciated stock with the charitable donation of the sale proceeds – is the end of the year. Individuals make changes and reposition their investments after assessing the performance of the investments during the year. But the financial markets are less predictable so this may be a year-round approach.

CHARITABLE GIFT OF SERVICES

Donors that have reduced cash or property contributions to charity during this economic downturn may see volunteering services as an attractive option. However, no matter what a client would pay for what the donor can do, the same services contributed to a charity are not deductible as a charitable contribution. Nor does a donor that permits a qualified charity free use of office space or other property generate a deduction; this is a gift of a partial interest in the property. But, a donor that incurs reasonable expenses while volunteering for a qualified charity can deduct those unreimbursed expenses. And mileage is deductible – for 2009, the donor can deduct $.14 for every mile traveled in his or her own vehicle while conducting service for the charity.

CHARITABLE GIFT ANNUITY

The charitable gift annuity is a great favorite with donors because of its relative simplicity and flexibility to complement personal financial planning. A charitable gift annuity is both a gift and an annuity – it is treated like a bargain sale for tax purposes. The donor enjoys a charitable deduction for the part that is considered the gift, and the donor (or the annuitant the donor names) receives a lifetime payout.

The lifetime payout is determined by the prevailing rates the charity sets by age. Like a commercial annuity, part of the payment is tax-free to the recipient for the duration of the annuitant's life expectancy. As noted above, the AFR is extremely low. At the time the gift annuity is established, the tax-free return of principal is measured. And a low AFR results in a larger tax-free portion to the annuitant.

Given these difficult economic times, many individuals might appreciate the fixed payout of a charitable gift annuity. After considering how a charitable deduction and larger tax-free component can bolster the effective payout rate of the charitable gift annuity, this might be an opportunity for donors to both give to charity and help themselves.

Altering a Charitable Pledge

A pledge is a donor's promise to make a gift to a charity in the future. Whether the charity wants to legally enforce a donor's unmet pledge is a difficult choice. Unfortunately, an inability to fulfill a pledge may become a more common instance during difficult economic times. There are, however, solutions to this problem:

- Defer payments
- Reduce the amount of the pledge
- Give a different asset (e.g., a valuable collectible instead of cash or appreciated securities)
- Change the form and timing of the gift (e.g., switch to a bequest)
- Help the charity to fundraise instead of personally giving

New Tax Developments

Naming a charity as a beneficiary for a deferred compensation plan does not compromise the corporation's deduction

A corporation requested a private letter ruling on the issue of whether naming a qualified charity (a 501(c)(3) organization) as a beneficiary of an employee's deferred compensation would preclude the deduction of the compensation pursuant to IRC Sec. 404(a)(5).

The IRS determined that, ultimately, if the spouse makes a qualified disclaimer with respect to the employee's deferred compensation or predeceases the employee, naming a qualified charity as the designated beneficiary of the deferred compensation will not preclude the employer's deduction of the compensation pursuant to IRC Sec. 404(a)(5).

PLR 200905016

Charitable gift annuity rates suggested by the ACGA are lowered

The American Council on Gift Annuities (ACGA) publishes recommended rates for charities. The ACGA promulgates its rates based on actuarial assumptions with the idea that after the investment of the entire gift, the residuum will be at least 50% of the initial gift amount, if the annuitants live only to their life expectancies. Recently, the Board of Directors of the ACGA approved a recommendation from the Rates Committee to reduce the charity's expected return assumption for investing the assets from 5.75% to 5.25%. A new rate schedule has been developed reflecting this change.

Recommended rates have been lowered by .4% to .7% at each age with a maximum rate of 9.5% at ages 90 and above. The new rates will qualify at all ages at an AFR of 2.4% or above. The new rate recommendations are effective on February 1, 2009. In the case of deferred gift annuities, there may be a few instances in which rates based on the ACGA's suggested schedule and methodology do not qualify when the AFR is quite low. In those instances, the deferred rates would have to be reduced to qualify.

www.ACGA-web.org

Treasury issues supplemental actuarial tables to account for sub-2.2% AFR

In Notice 2009-18, the Treasury provides supplements to the actuarial tables prescribed under Sec. 7520 of the Internal Revenue Code. The actuarial tables are used to value annuities, terms certain, reversions, and remainders. The interest rate required for these computations is 120% of the mid-term Applicable Federal Rate for the month of valuation (or, for transfers for charitable purposes, the interest rate for either of the two months preceding the month of valuation).

Recently, 120% of the mid-term Applicable Federal Rate fell below 2.2% (2.0% in February 2009). None of the published tables provides factors for the interest rates below 2.2%. This notice furnishes extensions to the existing tables for interest rates below 2.2%.

Notice 2009-18, 2009-10 IRB 1 (11 February 2009)

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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Planned Giving in Difficult Economic Times: Options to Consider

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Charitable Gift Annuities

Introduction

In our newsletter, Charitable Giving in Difficult Economic Times, we discussed several ideas that could help donors continue to give despite the recession. In this booklet, we expand on these ideas with the goal of helping you provide sound and timely advice to your philanthropically minded clients.

Charitable Lead Trusts

One method of charitable giving that can have a distinct advantage during this time of an under-performing economy and low applicable federal rates is the charitable lead trust (CLT). A CLT is an irrevocable trust established to pay a charity an annual income consisting of a specified dollar amount or a percentage of trust assets as determined every year [Reg. Sec. 20.2055-2(e)(2)(vi)]. At the end of the trust term (either a term of years or as based on a measuring life or lives), the CLT assets are distributed to non-charitable beneficiaries.

There are two types of qualified CLT: grantor CLT and non-grantor CLT [IRC Sec. 673(a)]. The grantor CLT distributes the assets (back) to the grantor at the end of the trust term. The non-grantor CLT distributes the trust assets to family members at the end of the trust term.

A primary reason for the current viability of a CLT is the extremely low applicable federal rate (AFR). The AFR is published by the Treasury Department every month to value annuities, life interests or interests for terms of years and remainder or reversionary interests [IRC Sec. 7520].The AFR is important because a low AFR increases the present value of the charity's income interest which reduces the value of trust assets expected to go to non-charitable beneficiaries.

Here are a few CLT approaches that might have particular appeal to donors:

Zeroing out the taxable gift of a charitable lead annuity trust

A charitable lead annuity trust (CLAT) is a qualified CLT with the income interest in the form of a guaranteed annuity. A non-grantor CLAT can be designed so that the taxable gift to non-charitable beneficiaries equals zero. This is true even if the qualified income interest to charity actuarially exceeds the value of the total amount.

For example, Eleanor decides to set up a charitable lead annuity trust to benefit the local art museum with the remainder to be split evenly between her two children. She has already used most of her lifetime gift tax exemption, so she would like the CLAT designed so the gift of the remainder interest does not generate any gift tax. She has decided to fund the CLAT with securities worth $1,000,000 and she would like the trust term to end in twenty years. The AFR for this month is 2.6% – the lowest AFR in several months. What can she do to ensure the taxable gift to her children is zero?

She should choose a payout percentage for her CLAT which, when multiplied with the annuity factor (check under IRS Publication 1457, Table B for a twenty year term and an AFR of 2.6%) will equal at least 100% of the present value of the charity's annuity interest. In this case, the annuity factor is 15.4429 so her payout percentage for the CLAT must be at least 6.475% so the present value of the remainder interest equals zero. Eleanor likes round numbers so she chooses a 7% payout percentage ($70,000 a year for twenty years). The likelihood is high that part of the trust principal will be eroded by the annual payments, but there is no estate or gift tax liability for Eleanor.

Note that this approach is particularly good when the AFR is low in relation to expected growth and earnings of the assets in trust.

The increasing payment charitable lead annuity trust

A CLAT can be designed to increase payments over the term of the trust. In Rev. Proc. 2007-45, the IRS published its sample charitable lead annuity trust forms (a safe harbor for practitioners). Under the section entitled, Annotations for Paragraph 2, Payment of Annuity Amount, the IRS outlines how the payments can increase: "Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded."

There are reasons why a donor might select an increasing payment over the life of the trust rather than a uniform level payment. Consider a CLAT created when the AFR is low – say 3.0%. The assets within the trust produce a consistent return of 7%. The benefit or accrual growth to the remainder distributed to non-charitable beneficiaries is four percent a year. If the trust instrument requires a level payout, the accrual benefit remains at that four percent. However, if lower payments are scheduled in the early years of the trust term, the CLAT has a chance to accrue greater value as compared to paying the level annuity. If the investments enjoy the greater compound growth in the early years of the CLAT, the non-charitable beneficiaries will have a larger remainder despite the somewhat larger payments scheduled later in the trust term.

Super grantor charitable lead trusts

A super grantor charitable lead trust (or intentionally defective non-grantor charitable lead trust) is a grantor trust for income tax purposes, but a non-grantor trust for gift and estate tax purposes. The super grantor CLT is designed so that the grantor retains a right that is enough to trigger grantor trust status, but not enough to pull the trust assets into the grantor's estate [IRC Sec. 675(4)].

One option is for the grantor to reserve the power for a non-adverse party to reacquire trust assets from the charitable lead trust [IRC Sec. 675(4)(c)].Though the grantor may be such a non-adverse party, this power must be exercised in a non-fiduciary role; it is possible that the grantor would violate the self-dealing rules of IRC Sec. 4941 if he were to use that power (though simply holding the power would be permitted under the incidental exception to the self-dealing rules under Reg. Sec. 53.4941(b)-3). A better choice might be for the grantor to choose a sibling to hold this power to reacquire the trust assets since a sibling is not considered a disqualified person under the IRC Sec. 4941 rules [PLR 200010036].

There are several benefits to creating a super grantor CLT including:

- The grantor can take an income tax charitable deduction for the present value of the charity's income interest.
- The income tax attributed to the grantor CLT is paid by the grantor and not from trust assets allowing the trust assets to grow at a greater rate. This could result in a relatively larger trust remainder left to go to non-charitable beneficiaries.
- The appreciation on the trust assets between the creation of the CLT and the end trust term is not subject to gift and estate taxation.

Problem assets for charitable lead trusts

Remember that charitable lead trusts are treated as private foundations with respect to certain administrative restrictions under which they must operate. The trust agreement must contain specific prohibitions against the following:

- Excess Business Holdings [IRC Sec. 4943]
- Self-Dealing [IRC Sec. 4941]
- Jeopardy Investments [IRC Sec. 4944]
- Taxable Expenditures [IRC Sec. 4945]

In particular, the private foundation prohibition against excess business holdings will apply if the value of the charitable interest exceeds 60% of the value of the total trust assets, or if all the trust income is not paid to the charitable beneficiary. When a closely held business interest is transferred to a charitable lead trust, it is generally prudent to limit the charitable income interest to 60% or less of the total value of the trust through proper selection of the payout rate and trust term. Also, in order not to run afoul of the excess business holdings prohibitions, a CLT may not own any voting stock of a corporation in which the donor and other disqualified persons together own more than 20% of the voting stock. (Though there is an exception for a CLT that receives the stock in a closely-held business as a gift or bequest and disposes of that stock within five years.)

Generation skipping transfer tax and charitable lead trusts

The generation skipping transfer tax (GSTT) is imposed in situations where successive generations could otherwise avoid paying successive estate taxes as property passed to younger generations [IRC Sec. 2601]. If a non-grantor CLT is designed to distribute assets to grandchildren or more remote descendants, GSTT becomes an issue.

A charitable lead unitrust or CLUT offers an opportunity to leverage the exemption because the GSTT allocation is made on the date the assets are transferred to the trust minus the charitable gift or estate tax deduction [IRC Sec. 2642(a)]. However, a CLAT does not permit this same leverage – to start, the charitable portion of the gift is not deductible for GSTT purposes. And, the exemption allocation for a CLAT is made on the date the assets are distributed to the grandchildren at the end of the trust term. As a result, it is that much harder to design a CLAT that shelters the transfer from GSTT if the assets are expected to increase in value during the trust term. Note that the amount of exemption allocated to the trust is increased annually by a percentage equal to the discount rate used in valuing the annuity interest.

Charitable Bequests

According to Giving USA, donors made charitable bequests that totaled $23.15 billion in 2007. One reason for the popularity of bequest giving is the traditional nature of giving to charity through a last will and testament. However, another compelling reason is that the donor continues to own the property to be distributed through a will. A bequest is a way to memorialize a commitment to charity, so it has a strong appeal to many donors. Even though it may be difficult to make a significant gift today, these donors can plan for a very significant gift from their estate.

Types of bequests

A testator can choose among different types of bequests when outlining how she wants her property to be distributed from her estate.

Specific bequest

A specific bequest bequeaths a certain dollar amount (e.g., $10,000) or certain other property (such as a home, art collection, etc.). This is the most popular form of bequest. Indeed, gifts of specific properties may be especially appropriate bequests both for tax and other reasons.

During estate administration, specific bequests are the first type of bequest satisfied. Thus, if the estate cannot satisfy all of the bequests made in a will, recipients of specific bequests are more likely to inherit than other estate beneficiaries. The downside is that the testator may dispose of the specifically bequeathed property during life, in which case the intended recipient is out of luck.

Note that a specific bequest of a certain dollar amount does not grow with an increase in the value of the estate during the donor's lifetime. In addition, some specific bequests may be problematic. For example, a bequest of a certain number of shares of a specific stock may raise valuation questions if the stock's value has changed dramatically since the donor's death. Or, a specific bequest of real estate may require site inspection, or environmental reviews, or other vetting by the charity.

Percentage bequest

A percentage bequest devises a set percentage, (e.g., 5%) of the value of the estate. A percentage bequest may be the best format for a charity to recommend since it lets the charity benefit from any estate growth during the donor's lifetime.

This is a good option for donors who have seen the value of their assets dramatically decline during the economic downturn. Including a percentage bequest in will has no out-of-pocket cost but it shows the donor's positive outlook and generosity. As the value of donor's assets rebound, this charity will (eventually) share in the improving value.

Residual bequest

A residual bequest distributes assets that remain after all other bequests as well as any tax or administrative costs have been satisfied.

Contingent bequest
A contingent bequest devises property only when those named as primary beneficiaries predecease the testator or if the named beneficiaries waive or disclaim the bequest.

Charitable bequests of specific forms of property

Some property is better or more suitable than other forms of property as charitable bequests.

Tangible personal property
Tangible personal property (e.g., artwork, collections, antiques, etc.) may be given to a charity by bequest. Generally, bequests of tangible personal property qualify for the estate tax charitable deduction for the current full appraised value without regard to whether the charity puts the property to a "related use" as is required for the income tax charitable deduction [IRC Sec. (e)(1)(B)(i)].

However, the artwork itself and its copyright are two interests in the same property. It is possible to make a charitable gift of the physical artwork and a separate charitable gift of its copyright so that both gifts qualify for the gift tax and estate tax charitable deduction (as a whole) but only if the following rules are met:

- The gift property must be tangible personal property with existent copyright protection under federal law,
- The charity is either a public charity or a private operating foundation, and
- The use of the property by the charity must be related to the organization's exempt purpose.

[IRC Sec. 2055(e)(4), 2522(c)(3)]

Ordinary income property
Ordinary income property given by bequest is also deductible at the current full appraised value for purposes of the estate tax charitable deduction. The reduction of the deemed amount of the contribution to cost basis required for the income tax charitable deduction does not apply for estate tax purposes.

Income in respect of a decedent
Income in respect of a decedent (IRD) is inherited property that would have been taxable income to the decedent if the decedent had received it before death. Since the earnings have never been taxed, IRD is subject to federal income tax. And, if the estate of the decedent is subject to federal estate tax, IRD is an estate asset and is also subject to federal estate tax. Donating IRD assets to a charity through a bequest can both create an estate tax charitable deduction and eliminate the negative income tax component because a qualified charity that receives the IRD assets is exempt from federal income tax.

For instance, a donor might want to set up a testamentary charitable gift annuity using an individual retirement account (IRA): the donor would designate a charity as beneficiary of his IRA at death. In return, the charity would agree to pay an annuity to a third party if she survived the donor. The annuity would not be assignable, revocable, or commutable (except for no consideration to the charity). Should the annuitant predecease the donor, the charity would receive the IRA balance without obligation. In PLR 200230018, a donor sought out IRS approval for this plan. The IRS noted that while the value of the IRA would be included in the donor's gross estate at death, his estate could claim an estate tax charitable deduction for the IRA's value, decreased by the present value of the annuity. And, better yet, the IRA proceeds would be income in respect of a decedent (IRD) to the charity, and not IRD to the donor's estate. Consequently, the IRA proceeds would not be taxed because of the charity's exempt status.

The donor also asked the IRS to rule that the annuitant's "investment in the contract" [IRC Sec.72(c)] is equivalent to the IRA proceeds conveyed to the charity, reduced by the estate tax charitable deduction. The IRS declined to rule on this "hypothetical" issue. The unresolved question is whether the annuitant would be entitled to the income tax deduction for estate tax paid on IRD [IRC Sec.691(c)]. If the answer is no, the annuity payments would be fully taxable, thereby discouraging testamentary gift annuities when the estate is subject to federal estate tax.

In a similar ruling involving an IRA bequest to a charitable remainder trust, the IRD deduction was only available to the trust, not the beneficiaries [PLR 199901023]. Because of the tier system applicable to charitable remainder trust payouts, this effectively delays, maybe indefinitely, the benefit of the IRD deduction to the trust beneficiaries.

Charitable gift of the remainder of a qualified terminal interest property

A qualified terminable interest property (QTIP) is property in a decedent's estate that, even though the surviving spouse's interest is subject to certain restrictions, can still qualify for the estate tax marital deduction (also includes property given to a spouse during life that qualifies for the gift tax marital deduction) [IRC Sec. 2056]. And the QTIP can be utilized to first provide for a surviving spouse, then for a charity, and not incur estate taxation.

It is true that the future value of the QTIP remainder interest to charity itself does not qualify for an estate tax charitable deduction when the decedent dies. However, the value of that remainder interest is shielded from the estate tax nonetheless because the entire transfer qualifies for the marital deduction in the decedent's estate.

Upon the death of the surviving spouse, the value of the remainder interest will be included in the now deceased spouse's estate, but the charitable gift of that remainder interest qualifies for an estate tax charitable deduction.

Charitable Gifts of Life Insurance

In difficult economic times, donors might look to give different assets instead of cash or appreciated stock. Charitable gifts of life insurance could be an option. Here are some different ways to make a charitable gift of life insurance.

Outright gift of an existing life insurance policy

A simple, outright gift of an existing life insurance policy can qualify for the income tax charitable deduction. To do so, the donor should assign all rights to charity (naming charity as policyowner and beneficiary). If the donor retains any rights in

the policy after the assignment, such as the right to borrow cash values or to change the beneficiary, the result would be a gift of a "partial interest" that would not qualify for the income tax (or gift tax) charitable deduction.

In order to properly complete an assignment of all rights in an existing policy to charity, the donor must contact the insurance company to request a transfer of ownership form or absolute assignment form. The charity should be named as both policy owner and beneficiary. Ownership of the policy is not transferred until the appropriate form is completed by the donor and received by the insurance company that issued the policy.

When an individual gives a life insurance policy to charity, the amount of his or her charitable contribution is deemed to be the lesser of:

- The value of the policy, or
- The donor's basis in the policy.

[IRC Sec. 72(e); Reg. Sec. 1.72-11(d)]

The "value" of an existing policy if the policy is paid-up (i.e., no further premiums are due) is its replacement cost or the single-premium sum that would purchase the same death benefit at the insured's current age [Reg. Sec. 25.2512-6(a)].

If further premiums are due, then the value of the policy is its interpolated terminal reserve, plus any unearned premium for the current period, plus any accrued dividends, minus any policy loan outstanding [Ibid; Rev. Rul. 59-195, 1959-CB 18]. Life insurance companies will provide this figure on IRS Form 712. The fair market value of a newly issued policy is the initial premium that was paid to bring the policy into existence.

The cost basis is defined as aggregate premiums paid less the sum of dividends received in cash and amounts surrendered.

Ordinary income limitation on the income tax charitable deduction

As noted, if a sale of the donated property on the date of the gift would have produced ordinary income, the amount of ordinary income reduces the charitable deduction allowable for the gift to charity. Because the surrender of a policy generally will produce ordinary income if the cash surrender value exceeds the basis of the policy, the income tax charitable deduction will be limited to the basis if there is a gain in the policy.

For example, Terence purchased a variable life policy some years ago and has paid total premiums of $30,000. He has experienced handsome investment gains in recent years (one of the lucky few), and the policy's cash value is now $50,000. However, Terence's deduction is limited to $30,000, his basis in the policy, even though the charity could surrender the policy for $50,000 cash. But if the reverse were true and the policy Terence owned suffered investment losses that reduced the policy's value to $20,000, Terence would only be able to deduct $20,000 – the lesser of the value of the policy or cost basis in the policy.

Gift of life insurance policy subject to loan

Donors should be aware that gifting a policy with an outstanding loan can be problematic. The transfer to charity is technically a bargain sale because the charity has assumed the policyholder's debt. So, the donor's basis must be allocated between the gift transaction and the sale transaction.

For example, a donor contributes a policy with a cash value of $100,000. Her basis in the policy is $30,000. Her outstanding loan against the policy is $60,000. The donor's basis should be allocated as follows:

Basis allocated to the charitable gift:
($40,000/$100,000) x $30,000 = $12,000

Basis allocated to the "sale":
($60,000/$100,000) x $30,000 = $18,000

Because a donor can take no more than the basis as a deduction (the basis or the fair market value, whichever is less), the donor's charitable deduction would be $12,000. And, the donor would receive ordinary income of $42,000 (after allocating the $18,000 in basis towards the loan value of $60,000).

Gift of policy dividends

Another approach using an existing policy is to give policy dividends to charity. Such dividends can be taken in cash by the policyholder and then donated to the charity under the usual charitable deduction rules for cash gifts.

Estate tax consequences

If an individual gives an existing policy to charity, its value will be removed from the gross estate, provided he or she lives for at least three years after the transfer. But even if the insured donor dies within three years, the death proceeds would wash out of the gross estate as an estate tax charitable deduction (with no percentage limits as in the case of the income tax).

Gift tax consequences

If a donor transfers his or her entire interest in a policy to charity, a federal gift tax return will not have to be filed, regardless of the value of the policy at the time of the gift. The gift tax charitable deduction shelters the entire gift from tax (with no percentage limits as in the case of the income tax) [IRC Sec. 2522].

Premium payments as charitable gifts made after a gift of an existing policy

Premium payments made by the donor after the policy has been transferred to charity may be treated as gifts "for the use of" charity if the premiums are paid directly to the insurance company. Gifts for the use of charity, rather than "to" charity, are deductible only up to 30% of the donor's adjusted gross income [IRC Sec. 170(b)(1)(B)].

On the other hand, transfers of cash to the charity in the amount of the premium are considered gifts "to" charity (which then pays the premiums itself), and are deductible up to 50% of the donor's adjusted gross income.

Cash gifts to enable the charity to meet its premium obligations are usually made 20-30 days prior to the premium due date. In this way, the charity can assure that premiums are paid in time to prevent a lapse of the policy. This also gives the charity a chance to maintain ongoing contact with the donor.

The donor may want to transfer appreciated property to the charity rather than cash to provide payment on the premium. The full value of the property will be deductible, including the

gain that has never been taxed, and the charity will not have to pay capital gains tax on the appreciation when it sells the property, unlike the donor who would sell the property to raise cash for premiums.

Gift of a new life insurance policy

The donor may apply for a new life insurance policy and name the charity as the owner and beneficiary. The value of the policy is the premium paid and this is the amount of the charitable deduction.

Another option is for the charity to apply for a life insurance policy on the life of the donor and pay the premium with funds provided by the donor. This approach does have the advantage that the donor never owns the policy so the donor never holds any incidents of ownership that could pull the policy death benefit into the donor's estate.

However, this approach could pose problems. The arrangement might violate state law regarding insurable interest, or jeopardize the donor's deduction by restricting the charity's use of the funds. The charity might not believe that investing assets in an insurance policy would be a prudent choice. Different charities have different gift acceptance policies so it is always wise to consult the charity early in the gift planning process.

Insuring a charitable pledge

On occasion, a benefactor may make a substantial pledge to a charity. It may be the donor's intent to pay this pledge over a period of years. Such a pledge may be guaranteed by the donor. If the donor purchases a life insurance policy (naming a charity as beneficiary) in the amount of the total pledge, then it is certain the commitment will be paid in full.

Once the pledge is satisfied, the donor may choose to change the beneficiary designation and leave the policy proceeds to his or her heirs, or to another charity.

Designating charity as beneficiary

If a donor does not desire to make an immediate gift of an existing policy, the donor may retain ownership and control of the policy but name a charity as beneficiary. This will not produce any income tax charitable deduction at the time the beneficiary designation is made, but it will result in an estate tax charitable deduction for the death proceeds passing to the charity at the insured donor's death.

Charitable Gift Annuities

The charitable gift annuity is a favorite with donors: simple to execute and flexible enough to fit many personal financial plans. The charitable gift annuity generates both an income tax deduction and a lifetime payout for one or two annuitants selected by the donor. And, when the applicable federal rate or AFR is low, the charitable gift annuity can have another benefit – a comparably larger tax-free principal component of the charitable gift annuity payment.

For a certain period of time, each annuity payment is comprised of a tax-free return of principal, interest taxed as ordinary income and, if the charitable gift annuity was funded with appreciated property, capital gain. The length of time for this income tax treatment depends on the age (or ages) of the annuitant(s). The determination for what part of the annuity payment is tax-free return of principal – interest income or, perhaps, capital gain is made using the exclusion ratio [IRC Sec. 72].

In order to calculate the amount of an annuity payment that will be characterized as a tax-free return of principal, the exclusion ratio is multiplied by the amount of each annual payment. The exclusion ratio is equal to the donor's investment in the contract (present value of the annuity) divided by the expected return (as determined by consulting IRS Tables V and VI). Investment in the contract is not equal to the full value of the transferred property. Rather it is equal to the present value of the gift annuity on the annuity starting date (for the immediate gift annuity, this is the contract date and for a deferred annuity, this is the date of first payment).

If appreciated property is transferred for a gift annuity and the donor is the sole annuitant, gain on the sale portion is recognized over the donor's life expectancy. If the donor outlives her life expectancy, the capital gain portion ends and all remaining payments are fully taxed as ordinary income. Note, in order to spread out the gains over the donor's lifetime, the gift annuity contract must require that the gift annuity interest is non-transferable except to the issuing charity.

And, ordinary income is that income which is not characterized as a return of principal, nor as capital gain. The excess of the charitable gift annuity payment above the tax-free principal or capital gain is considered interest.

For example, Benjamin (age 75) regularly volunteers at a local food pantry and donates cash as well. In thirty days, he has a series of bank certificates of deposit (CDs) that will mature. The available interest rates for CDs at this time are not what Benjamin would like. He recently read an article in the food pantry newsletter about the charitable gift annuity and the idea intrigued Benjamin. He especially liked the idea that part of each payment from the charity would be income tax-free.

After speaking to his financial and tax advisors, Benjamin decides he will make a gift of $10,000 in cash to the charity's gift annuity program. The applicable federal rate (AFR) at the time he makes his gift is 3.0% (the lowest rate in several months and the donor can select the AFR for the month of the gift or the two preceding months). The payout rate of the charitable gift annuity is 6.3% - $630 a year. The payment frequency is once a year.

Under this scenario, the tax-free return of principal over the next 13.4 years (Benjamin's life expectancy under the IRS Tables) is $461.79 – an exclusion ratio of 73.3%. If Benjamin had made his gift when the lowest available AFR was 6.0%, the tax-free return of principal would be $379.89 – an exclusion ratio of 60.3%.

In Conclusion

Historically speaking, Americans have proven to be generous givers to charities, even in challenging economic times. It is important to know different options for charitable giving available to your clients. With help from professional advisors, donors can fulfill their charitable goals in a way that best meets their personal plans as well.

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