THE CATHOLIC FOUNDATION

The Nuts and Bolts of Planning a Charitable Gift

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The Super Bowl is the championship game of the NFL, but over the years, it has also become a cultural event approaching national holiday status. Companies paid attention as the number of sports fans viewing the game on television increased and those fans started inviting family and friends to watch with them. Suddenly, there was an event most of the country watched, and the result was some of the most creative and memorable advertising in history:

- Mean Joe Greene and the kid with the Coke
- Apple's mesmerizing *1984*-style ad introducing the Mac
- Wendy's "Where's the beef?" dig at competitors
- The Budweiser Clydesdales and the Budweiser frogs

Thanks to the guidance of experienced advertising agencies, each campaign was well conceived and targeted to the specific audience watching the game.

When a donor starts thinking about making a sizeable charitable gift, it may feel daunting—especially if it's their first larger gift. Luckily, they can turn to a professional to help them consider the impact and target the right asset for donation. Whether the gift ends up being straightforward or creative, with the right professional guidance, donors can approach the charitable giving process with the confidence of a championship player.

In this issue of *The Good Advisor,* we provide a basic framework for helping clients who are contemplating making a sizeable donation, including assessing the impact, choosing the best asset to give, understanding the tax benefit, and factoring in future needs.

Assessing the Family Impact

A donor who is excited to further the work of a meaningful charity can easily overlook the impact such a gift can have on the mindset and stability of the family going forward.

Building a legacy. A sizeable gift can begin a family legacy of charitable giving, establishing philanthropy as a family value to be shared and passed on to future generations. Creating such a mindset can result in a compounding of gifts over time and across generations.

Maintaining harmony. Family members who support a gift in theory may not support the specifics. This is common with gifts of tangible assets (a painting, for example) or property (say, a vacation home). If family members have concerns, there are many alternative assets to be explored.

Protecting the future. A donor must also carefully consider the impact of the gift on the family finances. If there is concern that the donated assets could be needed in the future, there are many charitable giving options and solutions to consider, including testamentary gifts, life income gifts, or blended gifts that combine a smaller immediate gift with a larger gift in a will or trust.

Selecting the Best Asset to Give

When clients think about making a gift, they may first think of cash. However, there are many types of assets, and the best one to give will vary depending on the donor and the situation. You can help clients analyze how the gift fits within their financial and estate plans, consider the tax impact, and present informed options for consideration.

While the best asset for a particular gift depends on the donor's specific situation, the following information about broad categories of assets is a good starting point for the review process.

Cash

Cash is the most common asset for charitable gifts.

Pros and Cons. A cash gift is simple and easy. However, many of your clients own other assets that could offer more tax advantages.

Best Uses. Cash works well for smaller annual contributions, or for more substantial gifts when an individual has received a large performance bonus, inheritance, or other cash infusion. At these times, the donor may benefit from an income tax charitable deduction to offset the relatively outsized tax liability.

Deduction Limitation. 60% of AGI.[1]

Securities

A gift of securities is the most common non-cash gift. Donors typically give publicly traded stocks, but may also give bonds, mutual fund shares, or closely held stock.

Pros and Cons. This is a fairly easy gift to make, particularly if the stock is listed on one of the major exchanges or actively traded over the counter. However, some securities (such as closely held stock) require more attention in order to properly value the gift.

Best Uses. A donation of securities can help rebalance a portfolio due to changes in the market or in the donor's risk tolerance. In addition, highly appreciated stock held long term avoids capital gains tax when donated to charity—a potentially huge advantage. (On the other hand, depreciated securities do not make good gift assets. The donor should instead sell these assets, deduct the loss, then use the sale proceeds to make **a cash donation.)**

Deduction Limitations. The charitable deduction for a gift of securities to a public charity depends on the length of time the donor owned the securities.[2]

- Short-term securities (held for one year or less)—50% of AGI[3]
- Long-term securities (held for more than one year)—30% of AGI[4]

In either case, the donor can deduct the excess amount in subsequent years (up to five years).

Reduction Rules. A gift of short-term securities made to a public charity must be reduced by the amount of ordinary income that would have been realized if the securities had been sold.[5] A similar gift of long-term securities can be deducted for the full fair market value (FMV) on the date of the gift.[6]

Appraisal Requirements. Gifts of closely held stock require an appraisal that accounts for certain factors, including market price, book value, financial condition, earnings and dividend-paying capacity, previous sales of stock, the size of the block of securities to be valued, and the economic outlook.[7]

Retirement Accounts

Most people have a retirement plan account, such as a 401(k) or an individual retirement account (IRA), but people don't always think of using these assets to make a charitable gift.

Pros and Cons. Clients rely on these assets to provide income in retirement and often expect to pass anything remaining at death on to loved ones. However, retirement assets can be taxed twice—once in the estate and once to the recipient—making them a good candidate for a charitable gift. In addition, gifting retirement assets can avoid the complex rules that govern distributions or transfers of the assets after the account owner's death.

Best Uses. There are two ways to make gifts of retirement assets, each with distinct benefits.

(1) **Qualified Charitable Distributions (QCDs).** A QCD is a direct transfer by someone over age 70½ from an IRA to a qualified charity (not a Donor Advised Fund or a §509(a) Supporting Organization).[8] The QCD must be a gift that would otherwise have qualified for a charitable income tax deduction.[9] A person can direct up to $100,000 per year in this manner (annual aggregate amount), but contributions made after age 70½ count against QCD amounts. The distributed amount does not qualify for a charitable deduction, but it is excluded from income for federal tax purposes. Furthermore, the distribution counts toward the taxpayer's annual RMD if one is due.

(2) **Beneficiary Designations.** Using a beneficiary designation form to name the charity as a sole, partial, or contingent beneficiary of an IRA or qualified retirement plan account is an attractive and straightforward

way to make a testamentary charitable gift. This designation controls the distribution of the account at death (instructions left in a will or trust have no effect unless the assets are left to the estate or the trust).

Real Estate

Residential or commercial real estate held long term is an asset with great potential for charitable giving.

Best Uses. Clients who own property they no longer want or need may find it beneficial to donate, particularly if the property is highly appreciated in value. It is also possible to make a gift of a remainder interest in a personal residence or farm, which provides a current income tax deduction for the charity's future interest with no current change in lifestyle.[10]

Deduction Limitations. Long-term property is deductible up to 30% of AGI. Short-term property is deductible up to 50% of AGI.

Reduction Rules. The donor can deduct a contribution of real estate for FMV if held for the long term and avoid capital gains tax on the appreciated value. Otherwise, a gift will be valued at FMV minus any amount that would be considered ordinary income to the donor if the property were sold. The recapture of the depreciation deduction previously taken by the owner is considered ordinary income.[11] Also, if the owner regularly purchases and sells real estate for profit, the properties might be viewed as inventory, which is considered ordinary income property.[12]

Appraisal Requirements. An appraisal is necessary to properly value the real estate. The value is based on its "highest and best use," which may be different than the donor's use or the how the charity would actually use it.[13]

In addition, the charity itself will likely require documentation before accepting a gift of real estate (e.g., an environmental review, a clear title search). The donor will need to consult with the charity's development office.

Tangible Personal Property

Tangible personal property includes items such as antiques, artwork, precious gems, coin collections, and motor vehicles. It does not include land and improvements (buildings and permanent structures).[14]

Best Uses. These are typically items (or collections of items) expected to increase in value. However, there may come a time when the holder no longer wishes to manage their collection or wishes to give a specific item to a certain charity.

Deduction Limitations. Like other assets, long-term property can be deducted up to 30% of AGI and short-term property can be deducted up to 50%.

Reduction Rules. The donor can deduct a contribution of long-term property for the fair market value. A gift of short-term property will be valued at FMV minus any amount that would be considered ordinary income to the donor if the property were sold.

A donor must also consider the related-use rule: If the gift of tangible personal property is unrelated to the charity's exempt purpose, the deduction must be reduced by the amount of gain that would have been realized had the property been sold at its FMV.[15]

Furthermore, if the charity disposes of the item within three years, the donor is subject to an adjustment of the tax benefit.[16] An exception is made if the charity certifies that the property had a related-use function and was actually used in that capacity before its sale, or that the intended use of the property at the time of contribution became impossible or infeasible after the gift.[17]

Appraisal Requirements. In addition to the general requirement that all property valued at more than $5,000 have a qualified appraisal, certain types of property require additional or specific documentation. For instance, gifts of artwork require photographs and attachment of the appraisal itself. Further, due to abuse in claiming deductions, gifts of motor vehicles can be limited to the price the charity receives at a subsequent sale.[18]

Understanding the Tax Benefit

Though it is not the primary reason donors give, the income tax charitable deduction is the nexus between philanthropic planning and tax planning, and a donor making a sizable gift will surely want to secure a deduction if possible. But is the gift going to a nonprofit, a tax-exempt organization, or a qualified charity? They are all formed to achieve social good, and it is even possible that an entity could be all three things at once, but for the purposes of the Internal Revenue Code (IRC), these are three distinct types of organizations:

1. A **nonprofit** is a group organized for purposes other than generating profit and in which no part of the organization's income is distributed to its members, directors, or officers. Nonprofit status is conferred under state rather than federal law and the requirements of and benefits to such organizations can vary from state to state.[19]
2. A **tax-exempt organization** is a nonprofit organization that is exempt from federal income taxation (a clear advantage indeed).[20] However, to qualify for tax-exempt status, a nonprofit must be organized and operated exclusively for one or more exempt purposes. IRC §501(c) lists the types of organizations that may claim tax-exempt status.
3. A **qualified charity** is one that meets specific requirements under IRC §170(c) to be qualified for income tax purposes (but not necessarily qualified for gift and/or estate tax purposes). A gift must go to a qualified charity if the donor hopes to deduct some or all of the gift amount. If there is any question about whether a charity is a "qualified public charity," the donor can ask the charity to supply a copy of its IRS letter recognizing it as tax-exempt or consult the searchable database on the IRS website.

§501(c)(3) Organizations

There are 29 categories of tax-exempt organizations under IRC §501(c). However, when most people talk about a tax-exempt organization or charity, they usually are referring to an organization that qualifies under IRC §501(c)(3). This includes any corporation, community chest, fund, or foundation organized and operated for one of these purposes:

- Religious
- Charitable
- Scientific
- Testing for public safety
- Literary
- Educational
- Fostering athletic competition at the national or international level (if no funds go towards the facilities or equipment)
- Preventing cruelty to children or animals[21]

No net earnings generated by a §501(c)(3) organization can inure, in whole or in part, to the benefit of private shareholders or individuals. Furthermore, the organization cannot participate in political elections, nor devote a substantial part of its activities to influencing legislation by propaganda or otherwise.

Use the Legal Name

For a donor including a charitable bequest in a will, using the wrong legal name for the charity can thwart the intended gift. Ask the charity for its exact legal name before inserting it into a will or other legal document. Be as specific as necessary. For example, if the donor wants to help a large charity, ascertain whether the client wants to help the national organization or a local chapter, then use the appropriate name.

Also, keep in mind that a charitable organization may change its name, reorganize as a different entity, merge with another charity, or even cease to exist. When a client updates their estate planning documents, confirm the charity's correct legal name and business address. Your clients may also wish to list one or more additional qualified charities as contingent beneficiaries in planning documents in the event the primary charitable beneficiary is not able to accept the devised property.

50% Organizations vs. 30% Organizations

Not every charitable contribution will be deductible in the same way for income tax purposes.

A gift to a **50% organization** (a public charity) is deductible up to 50% of the donor's adjusted gross income (AGI). (Under the Tax Cuts and Jobs Act of 2017, cash gifts to public charities are deductible up to 60% of AGI.) 50% organizations include the qualified charities expressly described under IRC §170(b)(1)(A):

- Churches
- Hospitals and Medical Research Organizations
- Educational Organizations
- Governmental Units
- Publicly Supported Charities
- Certain Private Foundations
- Supporting Organizations

A gift to a **30% organization** (a private foundation) is deductible up to 30% of AGI. 30% organizations are those qualified charities not described above under IRC §170(b)(1)(A).

Factoring in Future Needs

Many donors considering a sizeable gift have concerns about how the donation may impact the family's future financial security. After all, an emergency or other unforeseen circumstances could require substantial funds—funds that might not be there if they've been given to charity. When such concerns forestall a charitable gift, though, donors not only lose the personal satisfaction of fulfilling their philanthropic objectives, they lose the income tax and/or estate tax savings available to those who make charitable gifts and bequests. Your knowledge of suitable options, including life income gifts and the wealth replacement technique, can prove invaluable for such donors.

Charitable Remainder Trusts

A charitable remainder trust (CRT) is an irrevocable trust that pays income to the donor (or other individual) during the trust term, with the remainder then going to charity.

- The donor transfers property to the trust (such as cash, stock, or even real estate).
- The donor designates one or more beneficiaries to receive annual (or more frequent) income payments for life (or joint lives) or a period of up to 20 years. The donor can be one of the beneficiaries, using the income to supplement other sources of retirement income and thereby allaying concerns that the gifted assets will

negatively impact future spendable income. (Because of this, the donor may feel able to make a larger gift than originally considered.)

- When the trust is funded, the donor qualifies for an itemized income tax deduction for the present value of the anticipated remainder interest.
- At the end of the trust term, the remaining assets are distributed to the donor's selected charity.

There are two types of CRTs:

- A **charitable remainder annuity trust (CRAT)** allows only one initial contribution. It pays out the same income amount every year—a fixed percentage of the trust's initial value. It comes in only one form.
- A **charitable remainder unitrust (CRUT)** allows for multiple contributions. It pays out varying annual amounts that represent a fixed percentage of the trust's annually revalued assets. It comes in four varieties, offering additional flexibility to meet a donor's specific planning needs.

Both types of CRT must make a specified annual payment of at least 5% (but not more than 50%) of the initial value (CRAT) or annual value (CRUT) of the trust assets. If the trust does not produce enough income, the trustee will need to invade the principal to make the required payout. The value of the charitable remainder must be at least 10% of the net fair market value of all trust property as determined at the time of the transfer. Donors and professionals should consider that the longer the trust will pay out to income beneficiaries (due to young or multiple lifetime beneficiaries), the more difficult it becomes to meet this requirement—and failing to meet the requirement jeopardizes the tax qualification of the trust.

Charitable Gift Annuities

A charitable gift annuity is a contractual agreement between a donor and a qualified charitable organization.

- The donor makes an irrevocable gift of cash or property (often long-term appreciated stock) to a qualified charity.
- In exchange, the charity agrees to pay a fixed amount periodically (quarterly, semiannually, or annually) to the donor for life and/or the life of a chosen beneficiary (two people maximum).
- The gift annuity transaction is not a straight quid pro quo, as the transfer is considered part gift and part annuity purchase. Thus, the donor qualifies for an immediate itemized charitable income tax deduction, but only for the gift portion of the transfer.
- The payments are based on the age of the income beneficiary, the gift annuity rate, and the amount of the gift. Generally, the older the annuitant, the higher the payout rate. The promise to make these payments is backed by the general assets of the charity.
- Annuity payments enjoy favorable taxation. Part of each payment is considered tax-free return of principal. Part is long-term capital gain (if the donor used long-term appreciated property, and is also the annuitant), spreading the capital gains tax payments out over many years. The remainder is taxed as ordinary income.
- Annuity payments can start immediately (no more than one year after the transfer) or be deferred for a period of time. This deferral is useful for high-earning donors who want to use payments to supplement other sources of retirement income in the future. Deferred gift annuities offer higher annuity payments and a higher tax deduction.

Compared to charitable remainder trusts, gift annuities are less expensive, less complex, and require a smaller gift amount. However, CRTs offer the donor greater flexibility in gift design—particularly in payout alternatives. In addition, a CRUT can often receive assets that would not be suitable for a charitable gift annuity.

Wealth Replacement

For clients less worried about retirement income and more concerned with leaving a sizeable inheritance to their children, the wealth replacement technique can be useful, as it lets donors make substantial gifts without adversely affecting family inheritances.

- The donor funds a charitable remainder trust (usually with long-term appreciated property). The transfer to the CRT (typically a CRUT) qualifies for a charitable income tax deduction for the charity's remainder interest.
- The donor funds an irrevocable life insurance trust (ILIT) with a life insurance policy.
- The donor uses the annual income from the CRT to make gifts to the ILIT to pay the insurance premiums. The ILIT employs "Crummey" powers to qualify these as gifts of a present interest, making them eligible for the annual gift tax exclusion ($16,000 in 2022).
- At the owner's death, the charity receives the remainder amount in the CRT. The ILIT receives the policy death benefits, which the trustee then distributes to the donor's heirs.
- This technique has the additional advantage of removing the donated property and the life insurance policy from the donor's gross estate. In addition, there is no capital gains tax due on appreciated property transferred to the CRT.

By essentially replacing the gifted assets with life insurance proceeds, the donor can make a significant charitable gift while maintaining the original size of the children's inheritance.

Basketball at the Super Bowl

In 1993, Michael Jordan and Larry Bird—two of the world's most popular, skilled, and competitive basketball players—were featured in a Super Bowl commercial for McDonald's. The premise was an outrageous game of HORSE in which the winner received a Big Mac. While it may not have been intuitive to suggest that basketball players would be a great fit for a championship football game, McDonald's understood that the players' star power and charisma, combined with the clever premise, would result in a win.

A donor planning a large charitable donation may also have uncommon ideas. With your knowledge and guidance concerning rules and options, those creative gift ideas may just result in a win-win for the donor and the charity.

ENDNOTES

1 IRC §170(b)(1)(A); Reg. Sec. 1.170A-8(b).

2 IRC §1222.

3 IRC §170(b)(1)(A).

4 IRC §170(b)(1)(C)(i).

5 IRC §170(e)(1)(A).

6 Ibid.

7 Reg. Secs. 25.2512-3(a), 20.2031-3.

8 IRC §408(d)(8).

9 IRC §408(d)(8)(B)(i).

10 IRC §170(f)(3)(B)(i).

11 IRC §170(e)(1)(A).

12 Ibid.

13 *McGuire v. Comm'r*, 44 TC 801 (1965).

14 Reg. Sec. 1.48-1(c).

15 IRC §170(e)(1(B)(i).

16 IRC §170(e)(7).

17 IRC §170(e)(7)(D).

18 IRC §170(f)(12).

19 For example, see the Revised Uniform Unincorporated Nonprofit Association Act—a law promulgated by the National Conference of Commissioners on Uniform State Laws—which governs all unincorporated nonprofit associations that are formed or operate in a state that adopts the act.

20 IRC §501(a).

21 Reg. Sec. 1.501(c)(3)-1.

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