THE CATHOLIC FOUNDATION

Giving in an Uncertain Economy: The Strategic Tax Benefits of Charitable Giving

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Antarctica is one of the most inhospitable places on Earth. It is covered by a sheet of ice and has recorded the world's lowest temperature at -128.6 degrees Fahrenheit.[1] Yet its scientific importance is so great that in 1955, the U.S. Navy sent a group of Seabees (the Construction Battalion) to establish a naval station. Unsurprisingly, the men were soon cold and homesick.

In New Jersey, teenage brothers Jules and John Madey connected with the group on their ham radio[2] and soon realized their radio provided the best connection between the men and their family and friends at home. Jules in particular worked tirelessly to relay calls, deliver messages, and share news, and this great gift of time and effort contributed to the ultimate success of the mission despite the harshest circumstances. A naval radio operator said:

> The men would come into the ham shack … and I'd put them through to Jules. I'd watch the person change from morose to his morale going way up as soon as he heard Jules' voice, putting through the phone patch. I do not think Jules could possibly understand at his young age how important he was to us.[3]

In uncertain economic times, donors may hesitate to give. Sometimes, it is only with professional guidance that a potential donor makes the connection—it is possible to remain comfortable financially while contributing to the success of an important charitable mission. In this quarter's newsletter, we look at tax-wise giving, starting with a deeper look at the charitable income tax deduction and the charitable gift annuity, then moving on to an overview of the tax-effectiveness of various gift assets.

The Charitable Income Tax Deduction

When the economic forecast looks uncertain, donors tend to focus on protecting their family's financial health, becoming more reluctant to make substantial charitable gifts. The truth, of course, is that donors who continue to give will positively impact the vital work of the charitable recipients—but they will also reap personal benefits, most often in the form of tax advantages.

Understanding the tax benefits of charitable giving begins with a look at the basics of the charitable income tax deduction. The general rule, as stated in §170 of the Internal Revenue Code (IRC), states that "there shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year."[4]

The law sets out the clear framework for obtaining a charitable deduction—any taxpayer who itemizes deductions may deduct a contribution to a qualified charity in the year in which the contribution is made. To do this, the donor must meet the two basic requirements for claiming a charitable deduction:

1. Determine the fair market value of the property donated to the charity, and
2. Retain documentation to substantiate the donation (described in the Treasury regulations as maintaining adequate records to substantiate the gift).[5]

The donor can satisfy the substantiation requirement with a canceled check, a receipt from an online contribution or electronic fund transfer, a bank record, or a letter or other written communication from the charitable recipient. A written communication from the charity should list the name of the charity plus the date and amount of the contribution.[6] If the donation is made in a circumstance where a receipt from the charity is impractical (such as a donation made at a charity drop-box), the taxpayer must keep a reliable written record of each item donated.[7] Of course, the taxpayer's reliable record must include all of the information required in the regulations.[8]

The IRC lists additional substantiation requirements as the amount of the gift increases:

- **Cash donation of $250 or more.** The Code requires the donor to obtain a "contemporaneous written acknowledgment" for the donation.[9]
- **Gifts of property over $500 but not more than $5,000.** The donor must include a description of the donated property with their federal income tax return on IRS Form 8283.[10]

- **Gifts of property worth $5,000 or more.** The donor must obtain a qualified appraisal of the donated property and include an appraisal summary with the tax return.[11] If the donation is non-publicly traded stock, certain publicly traded securities, or a contribution by a C corporation, the donor must maintain additional records.[12] However, publicly traded stock that exceeds $5,000 but is less than $10,000 and non-publicly traded stock with a value less than $10,000 do not need a qualified appraisal.[13] Obviously, the appraisal of stock can be difficult depending on the availability of market quotations.

While an income tax deduction is an important benefit for donors, it does not eliminate the cost of making the gift and is not typically the primary reason donors give. After all, altruism creates dopamine—the "happiness chemical"—which helps account for American giving during the pandemic. In that most uncertain of times, 2020 and 2021, donors gave $471[14] and $485 billion, respectively.[15]

Donors must use caution, as certain gifts are not usually deductible, including:

- Volunteer time (work not done as a professional service)
- Donations to foreign charitable organizations
- Donations made to specifically benefit an individual or small group of individuals
- Donations made in a quid pro quo manner where the donor receives something of value back from the charity

The Charitable Gift Annuity

Those who want to make a charitable gift but are concerned about future income have a tax-advantaged way to meet their goals—the charitable gift annuity (CGA). The CGA is a contractual agreement between the donor and the charity in which the donor makes a gift to the charity and the charity, in return, provides a lifetime income stream to one or two annuitants selected by the donor. An annuitant must be a living person (not a trust, corporation, LLC, or charity), and the payments must be made for life, not a term of years or a specified number of payments. (A charitable remainder trust, on the other hand, can offer payments for a term of up to 20 years OR for the life or lives of the income beneficiaries.)

The gift annuity transaction is not a straight quid pro quo, though. The IRS views a charitable gift annuity as part gift and part annuity, meaning the present value of the donor's annuity is less than the value of the property transferred. The donor receives an income tax charitable deduction in the year of the gift, but only for the gift portion of the transfer, calculated as the value of the contributed cash or property less the present value of the annuity payments.

Only qualified charitable organizations may issue gift annuities and they are often subject to state regulations. In some cases, state laws require issuing charities to maintain segregated reserves to cover their potential obligations to annuitants under gift annuity agreements.

Determining the Payout

The charity sets the payout rates for the CGA based on the annuitant's age—generally, the older the annuitant, the higher the payout rate. However, the offered payout rate must also pass the 10%-residuum-to-charity rule set forth in the Internal Revenue Code.[16] The American Council on Gift Annuities (ACGA), a nonprofit with a volunteer board made up of active planned giving professionals, conducts research and publishes suggested CGA payout rates.[17] At its Board of Directors meetings, the ACGA reviews the assumptions that go into the suggested CGA rates and adjusts the rates if necessary. The ACGA suggested rates are "generally … designed to produce a target gift for charity at the conclusion of the contract equal to 50% of the funds contributed for the annuity."[18] While the charity may set its own rates, many charities follow the rates suggested by the ACGA.

The ACGA raised CGA rates starting July 1, 2022.[19]
Rates for a single life annuity are:

Age	70	75	80	85	90
Payment rate	5.3%	6.0%	7.0%	8.1%	9.1%

Once the donor and charity have set the amount of the annuity payment in the CGA contract, the charity cannot offer any adjustment, such as increasing the annuity payments based on positive changes in the market or investment performance.

Taxation of the Payout

At the outset, a CGA payout can be taxed as income in three ways:

- **Tax-free return of principal.** Part of the annuity payment is considered a tax-free return of principal until the assumed cost of the annuity (as determined by IRS tables) has been recovered.
- **Long-term capital gain.** If the donor is the annuitant and funds the CGA with long-term capital gain property, part of each annuity payment will be taxed as long-term capital gain.
- **Ordinary income.** After the tax-free and capital gain portions of an annuity payment have been determined, the balance of the payment represents ordinary income.

Once the annuitant attains life expectancy, all principal attributable to the sale portion will have been recovered free of income tax and all capital gain attributable to the sale portion will have been recognized. Thereafter, the entire annuity payment will be taxable as ordinary income.

CGA Benefits

The CGA provides a dual benefit—a gift for the charity and an income stream for the annuitant. This combination alone makes the CGA a unique and attractive giving option, especially during uncertain economic times. Many donors appreciate the additional benefits of the CGA as well:

- Newly increased gift annuity rates lock in a higher fixed payment for life.
- Payment amounts generally increase for older donors and for donors who choose to defer the start of payments.
- The present value of the charity's interest in the gift annuity qualifies for a charitable tax deduction.
- Part of each annuity payment is considered tax-free return of principal.
- When the donor transfers appreciated property in exchange for the CGA, the resulting capital gains tax on the non-gift portion of the transaction can be spread out over the donor's life expectancy (if the donor is the annuitant).

Judging the Tax Effectiveness of Gift Assets

Of course, CGAs are not the only way to make a tax-wise gift. There are three main criteria for judging the tax effectiveness of a charitable contribution of a particular asset:

1. **AGI Percentage Limits.** In the year of the charitable contribution, the donor can take an itemized deduction for income tax purposes.[20] However, this deduction is limited to a percentage of the donor's adjusted gross income (AGI) for that tax year.[21] Any excess value of the contribution not deducted can be carried over into subsequent years (up to five).[22] The percentage limits do not apply to the gift or estate tax charitable deduction. For purposes of this discussion, we will presume the gift is to a public charity described as a 50% organization.[23]
2. **Reduction Rules.** Generally, a donor can take an itemized federal income tax deduction for the fair market value of the charitable contribution of property.[24] However, this deduction must be reduced by the amount

that would be considered ordinary income if the donor had instead sold the property.[25] The reduction rules are for income tax deductions only and do not apply to the gift or estate tax charitable deduction.

3. **Appraisal Requirements.** A contribution of property worth more than $5,000 generally requires an appraisal made by an independent and qualified appraiser to establish the value for deduction purposes.[26] The appraisal requirement applies to charitable deductions made by individuals, corporations, and partnerships.[27]

Using these criteria, let's take a brief look at the tax effectiveness of various gift assets.

Cash

Cash is the most common charitable gift because of its simplicity. The deduction for a gift of cash made to a public charity cannot exceed 60% of the donor's adjusted gross income (AGI) in the year the gift is made.[28] There is no reduction rule or need for an appraisal, but a cash gift does not offer additional tax advantages such as avoiding capital gains tax.

Donor Impact. Cash may not be the most advantageous gift asset during a difficult economy when donors are likely concerned about maintaining enough liquidity to handle increased economic challenges. However, a substantial gift of cash may be advisable when the donor has realized a large amount of cash in a particular year (e.g., from a substantial performance bonus or the sale of a business interest), as the income tax charitable deduction can offset the relatively outsized tax liability—but even then, there may be more tax-efficient assets in the donor's portfolio.

Securities

A gift of securities is the most common type of non-cash gift and includes publicly traded stocks, bonds, mutual fund shares, and closely held stock. It is an easy gift to make, especially for stocks listed on major exchanges or actively traded over the counter. (Closely held stock requires more attention and proper valuation.)

AGI Percentage Limitation. The charitable deduction for a gift of securities depends on the length of time the donor owned the securities:[29]

- A gift of short-term securities (one year or less) to a public charity cannot exceed 50% of the donor's AGI in the year the gift is made.[30]
- A gift of long-term securities (more than one year) made to a public charity cannot exceed 30% of the donor's AGI in the year the gift is made.[31]

The excess amount of either of the above can be deducted in subsequent years (up to five years).

Reduction Rules. A gift of short-term securities must be reduced by the amount of ordinary income that would have been realized if the securities had been sold rather than donated.[32] A gift of securities held long term can be deducted for the full fair market value of the securities on the date the gift is made.[33]

Appraisal Requirements. No qualified appraisal is required for a gift of securities listed on a market exchange—the value is simply the mean price on the date of the gift.[34] For a gift of non-publicly traded stock valued at less than $10,000, no appraisal is needed.[35] A gift of closely-held stock, though, does require an appraisal that accounts for certain factors, including:

- The market price of stocks of corporations engaged in the same or similar kind of business
- The book value of the stock and the financial condition of the business
- The earnings and dividend-paying capacity of the business
- Sales of the stock and the size of the block of stock to be valued
- The economic outlook for the industry and the particular business[36]

Donor Impact. Giving securities can be beneficial during a difficult economy, as long-term appreciated securities may allow the donor to make a significant gift without having to pay capital gains taxes and without

negatively impacting the donor's overall liquidity. This is also useful for underperforming assets or as part of a portfolio rebalancing (to better align with market changes or shifting risk tolerance).

Securities worth less than the cost basis are not good candidates for charitable gifts. The donor must deduct the fair market value (FMV) of the stock—a distinct disadvantage when FMV is less than the donor's cost basis. In this instance, the donor is better off selling the stock and giving the proceeds to charity, then deducting both the loss and the charitable contribution.

Real Estate

Residential and commercial property enjoyed a long growth period, and despite the recent downturn in property values, real estate remains an asset most often held long term with great potential for charitable giving.

AGI Percentage Limitation. A contribution of real property held in the long term can be deducted up to 30% of AGI in the year it is donated (50% for property held in the short term).

Reduction Rules. A gift of property held for the long term can be deducted at fair market value. A gift of property held for the short term can be deducted at FMV minus any amount that would be considered ordinary income to the donor if the property were sold. The recapture of the owner's previously taken depreciation deduction is considered ordinary income property.[37] Also, if the owner regularly purchases and sells real estate for profit, the property might be considered inventory, which would make it ordinary income property.[38]

Appraisal Requirements. A donor must get an appraisal to properly value real estate. The value is based on the property's "highest and best use," which may be different from the donor's purpose or how the charity intends to use it.[39]

In addition to the appraisal, the donor will likely need to obtain additional documentation (e.g., an environmental review or a clear title search) to meet the charity's requirements for accepting gifts of real estate. Typically, the donor must consult with the charity's development office to initiate such a gift.

Donor Impact. For a donor who wishes to use real estate to make a gift but is hesitant to do so during a difficult economy, a charitable gift of a remainder interest in a personal residence or farm is a possibility that allows for a significant contribution without a change in personal lifestyle.[40] Under this arrangement, the donor continues to live in the home or use the property (and maintain it) for life, with the property irrevocably transferred to charity upon the owner's death. The donor receives an income tax charitable deduction for the discounted present value of the charity's future interest.[41] This remainder value is determined using the value of the land and improvements reduced by the value of the donor's lifetime use of the property.[42]

Beneficiary Designations

Naming the charity as a beneficiary of an IRA, qualified retirement plan account, or life insurance policy is an easy, straightforward way to make a substantial charitable gift without impacting the donor's current budget. The beneficiary designation controls the distribution of the account or policy death benefit—instructions in a will or trust have no effect if the asset is not left to the estate or the trust. The plan or account administrator or life insurance company can supply a change of beneficiary form for the owner to complete. A charitable beneficiary designation is the simplest way to donate any of those assets.

Tangible Personal Property

Tangible personal property (TPP) includes items such as artwork, antiques, jewelry, precious gems and metals, or even motor vehicles (but NOT land and improvements, buildings, or permanent structures).[43] These items can make excellent gifts during a difficult economy as they can typically be donated without impacting the owner's spendable income. Many times, the donor purchased these items to be part of a managed collection expected to increase in value, but for any number of reasons, the donor now wants to make a gift of an item or the entire collection.

AGI Percentage Limitations. A contribution of tangible personal property can be deducted up to 30% of AGI (if held long term) or 50% of AGI (if held short term) in the year it is contributed.

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

To deduct the full FMV, the donor must also meet the related-use rule: If the tangible personal property is unrelated to the charity's exempt purposes, the deduction must be reduced by the amount that would have been considered gain had the property been sold at its fair market value.[44]

Furthermore, if the charity disposes of the item within three years of its contribution, the donor is subject to an adjustment of the tax benefit according to the following schedule:

- If the charity disposes of the property in the same tax year the gift is made, the donor's deduction is the basis.
- If the charity disposes of the property in year two or three after the contribution, the donor must include as ordinary income for the taxable year in which the disposition occurs an amount equal to the excess (if any) of the amount of the deduction over the donor's basis in the property at the time of the contribution.[45]

An exception is made if the charity certifies in writing 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 to implement after such gift.[46]

Appraisal Requirements. All property valued at more than $5,000 needs a qualified appraisal. However, 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 sale price the charity realizes at a subsequent sale.[47]

Donor Impact. Like a gift of appreciated stock or real estate, there are advantages to giving tangible personal property held long term. However, a donor must be careful to observe the related-use rule and to consider the place the TPP value had in their overall estate and financial plan. If a donor is counting on a future sale of the item or collection to provide needed income, the donor should consider other assets to make a gift. However, if the donor has significant collections or is not relying on the eventual sale to produce income, the donation of TPP might be an excellent option.

The Circle of Giving: Charitable Giving and Giving Back

The ham radio communications efforts by Jules and John Madey were key to keeping up the morale of the men who found themselves in Antarctica's harsh environment. Their selfless sacrifice of time (and sleep!) also helped create a pattern of success and giving back that followed Jules and John for the remainder of their lives. John went on to invent the free-electron laser while working at Stanford University. Jules invented the EZ-pass for the toll road system used by New York and New Jersey.

During uncertain times, donors can find effective ways to continue giving to meaningful organizations. These gifts not only provide financial support but also raise morale for both the charity and those the charity serves. In this way, donors can also create a pattern of success and giving back, reaping the benefits of important tax savings while helping others.

ENDNOTES

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4 IRC §170(a)(1).
5 Treas. Reg. §1.170A-13(a)(1).
6 *Id*.
7 Treas. Reg. §1.170A-13(b)(1)(iii).
8 *Id*. See also Treas. Reg. §1.170A-13(b)(2)(ii).
9 IRC §170(f)(8)(A).
10 IRC §170(f)(11)(B).
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14 Haleluya Hadero and The Associated Press, "Americans gave a record $471 billion to charity in 2020," *Fortune*, June 15, 2021.
15 Anna Pruitt and Jon Bergdoll, "Americans gave a near-record $485 billion to charity in 2021, despite surging inflation rates," *The Conversation*, June 21, 2022.
16 IRC §514(c)(5).
17 "Who We Are," American Council on Gift Annuities.
18 "Current Gift Annuity Rates," American Council on Gift Annuities.
19 *Id*.
20 Treas. Reg. §1.170A-1(a).
21 IRC §170(b)(1)(B).
22 IRC §170(d)(1); Treas. Reg. §§1.170A-8, 1.170A-10.
23 IRC §170(b)(1)(A).
24 Treas. Reg. §1.170A-1(c)(2): "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts."
25 IRC §170(e)(1)(A); Treas. Reg. §1.170A-4(a)(1).
26 IRC §170(f)(11)(C); Treas. Reg. §1.170A-13(c).
27 *Ibid*.
28 IRC §170(b)(1)(G)(i); Treas. Reg. §1.170A-8(b).
29 IRC §1222.
30 IRC §170(b)(1)(A).
31 IRC §170(b)(1)(C)(i).
32 IRC §170(e)(1)(A).
33 *Ibid*.
34 Treas. Reg. §§25.2512(b)(1), 20.2031-2(b)(1).
35 Treas. Reg. §1.170A-13(c)(2)(ii)(B)(1).
36 Treas. Reg. §§25.2512-3(a), 20.2031-3.
37 IRC §170(e)(1)(A).
38 *Ibid*.
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40 IRC §170(f)(3)(B)(i).
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42 Treas. Reg. §1.170A-7(c).
43 Treas. Reg. §1.48-1(c).
44 IRC §170(e)(1)(B)(i).
45 IRC §170(e)(7).
46 IRC §170(e)(7)(D).
47 IRC §170(f)(12).

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