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Opportunities and Pitfalls:
Crocodiles and Cobras and Quicksand! Oh My!

The summer of 1982 was pretty good for American teenagers. They were trying Pepsi Free, talking about E.T. going home, cheering Rocky for beating Apollo, and debating whether they could get through *Poltergeist* in the theater without being scared. While goofing off with friends and seeing movies was always fun, video games at home became a favorite activity for most kids. EVERYBODY (at least, according to teens trying to sway a parent toward a purchase) played favorites like *Space Invaders* or *Fishing Derby* on their Atari or Intellivision consoles.

In the summer of 1982, *Pitfall!* was released—a video game that introduced players to vibrant graphics and changing game screens that helped pave the way for modern games. Gamers played Pitfall Harry, a jungle adventurer who ran across the screen jumping on crocodiles, avoiding cobras, and swinging on vines in an attempt to reach a treasure before the 20-minute timer ran out. *Pitfall!* epitomized the risk / reward concept, guiding gamers to work through the potential pitfalls for the opportunity to reach the treasure.

Financial, gift, and estate planning may not be as fun as making Pitfall Harry dash across an RCA television screen, but it does present a greater number of dangers and opportunities. For example, a client has the opportunity to deduct a gift—if the client meets certain requirements and itemizes their taxes. A client has the opportunity to make a large gift of real estate—if the client understands the tax implications of donating property with a mortgage.

Luckily, clients can turn to financial professionals to help them avoid the pitfalls and reach their goals. This issue of *The Good Advisor* imagines the charitable giving version of *Pitfall!* and looks at three levels of the game:

Level One: Securing a Deduction
Level Two: Donating Real Estate
Level Three: Giving While Protecting Finances

Level One: Securing a Deduction

Typically, the first level of a game is the most basic. So, in level one, our charitable adventurer, Sonya, is seeking the opportunity to support her alma mater. What pitfalls must she avoid to reach her goal?

Pitfalls—Qualified Charities, Deduction Limitations, and Gift Substantiation

Sonya received a $150,000 bonus from her employer for developing a commercially top-secret nanobot. She wants to share the rewards of her work and decides to give $50,000 to her alma mater. Since she has a flair for the dramatic, she slips on her beige trench coat and big sunglasses, stuffs the cash in a new briefcase, and heads off toward campus. On the way, she runs into her advisor, who asks about her “old-timey spy costume.” She details her plan to drop the briefcase at the door of the development office and walk away. Luckily, her advisor warns her that she’s about to fall into a trap! Her plan would not allow her to claim a charitable income tax deduction for her gift.

Sonya soon realizes there are many pitfalls that stand between her and taking a charitable deduction for her gift of cash. To be successful, she must do the following:

1. **Give to a qualified charity.** The Internal Revenue

Code (IRC) provides a list of entities that qualify to receive a charitable contribution in §170(c). This list includes governments, certain veterans' organizations, types of cemeteries, and the familiar entities "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition."[1]

2. **Itemize her taxes.** The deduction for charitable contributions is available to taxpayers who itemize their deductions, but itemizing is less common today with the high standard deduction.

3. **Apply the proper limitation to the deduction.** Gifts of cash to public charities or certain foundations limit the charitable income tax deduction to 60% of the taxpayer's contribution base (the taxpayer's adjusted gross income without any net operating loss carrybacks).[2] These organizations include churches, hospitals, medical research organizations, educational organizations, governments, publicly supported charities, supporting organizations, and certain private foundations.[3] If the donor has an amount of the deduction remaining, the donor may carry that amount forward for up to an additional five years.[4]

For cash gifts to organizations not described under IRC §170(b)(1)(A)—generally speaking, this would be private foundations as defined under IRC §509(a)—the taxpayer's gift is limited to 30% of AGI. Noncash gifts (such as long-term capital gain property, inventory, and tangible personal property) have additional limitations under the IRC.[5]

4. **Provide proper gift substantiation.** The taxpayer must also provide substantiation of the charitable gift. For a gift of cash, the taxpayer must maintain a record of the contribution, such as a canceled check, a receipt, a written letter from the charitable organization, or some other reliable written record showing the following information:[6]
   - The name and address of the donee organization
   - The date and location of the contribution
   - The amount of the contribution or a description of the gift property in reasonable detail under the circumstances (if the gift is a security, the name of the issuer for stock, the type of security, and whether the stock is publicly traded and where it is traded)
   - The fair market value (FMV) of the property at the time of the contribution and how the FMV was determined
   - The basis of the property, if the contribution was one involving certain ordinary income and capital gain property (see IRC §170(e))

Opportunity—Claim a Charitable Income Tax Deduction

Sonya nods wisely in agreement with her advisor and promises to request acknowledgment of her gift at the time she hands it over—a written record that includes the college's name, the date, and the amount of the contribution. Then, assuming she otherwise qualifies, she will have what she needs to be eligible to claim a deduction for the gift.

Before they part, Sonya's advisor notes that while it might not be as fun as a briefcase full of cash, making a gift with a check or electronic transfer is faster and would inherently provide the necessary substantiation for her to claim the deduction.

Taxpayers must always be mindful that they are responsible for keeping the records. Treasury Regulation §1.170A-13(a)(2)(i) states, "The reliability of the written records described in paragraph (a)(1)(iii) of this section is to be determined on the basis of all of the facts and circumstances of a particular case. In all events, however, the burden shall be on the taxpayer to establish reliability."

Level Two: Donating Real Estate

Real estate has been important to humanity—it gives sustenance, serves as an identifier of our place of origin, and often provides wealth to those who own it. Therefore, in moving up a level, it is not surprising that our next charitable adventurer, Phineas, is seeking to use real estate as a charitable gift. What pitfalls must he avoid to reach his goal?

Pitfalls—Qualified Appraisals, Deduction Limitations, and Mortgage Implications

Phineas finished a design job in Chicago and immediately accepted a new position with an architecture firm in Miami. As part of his move, he

planned to sell his residential farm in central Illinois. Instead, he decides to donate the farm to his favorite charity. Phineas is knowledgeable about real estate, so he recently had the farm appraised by a qualified appraiser and has a copy of the appraisal. At this point, the farm has a fair market value (FMV) of $600,000 and a remaining mortgage amount of $150,000.

While Phineas feels comfortable with real estate transactions, he wants to make sure there aren't any issues he hasn't considered, so he checks with his advisors. He learns there are more potential pitfalls than he realized, and if he wants to make a successful gift of real estate, he will have to do the following:

1. **Obtain an appraisal to determine the FMV.** This is a necessary step that Phineas has already taken. If the value is between $5,000 and $500,000, the taxpayer must obtain a "qualified appraisal" and include an appraisal summary with the tax return.[7] If the real estate is worth $500,000 or more, the taxpayer must obtain a qualified appraisal and attach a copy of the appraisal (not just an appraisal summary) to the income tax return for that year. The value of the real estate is based on its "highest and best use," which may be different than the donor's purpose or how the charity would actually use it.[8]
2. **Consider the tax implications of giving ordinary income property.** If the owner regularly purchases and sells real estate for profit, the properties might be considered inventory, which is ordinary income property.[9] As a result, a gift of real estate inventory will be valued at fair market value minus any amount that would be considered ordinary income to the donor if the property were sold. Any depreciation previously taken as a deduction will be recaptured.[10]
3. **Apply the proper limitation to the deduction.** Generally, a donor may deduct a contribution of real estate held for the long term for FMV, but this deduction is limited to 30% of the donor's AGI.[11] A donor may carry forward any excess deduction for up to five years. If a donor gives real estate held for the short term (less than one year and one day), the charitable deduction is limited to the lesser of the asset's FMV or the donor's cost basis in the asset. If the donor elects a cost basis, the deduction is 50% of AGI.[12]
4. **Consider the tax implications of giving mortgaged property.** A donor who intends to transfer a property subject to a mortgage should understand that the amount of a charitable contribution is limited to the donor's equity in the property. The value of the real property donated is reduced by the mortgage or any other encumbrance on the property. In addition, Federal tax regulations provide that the mortgage in a gift of real estate is treated as an amount realized by the donor, even if the charity does not assume or agree to pay the debt.[13] According to Treas. Reg. §1.1011-2(a)(3):

   > If property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which section 1011(b) and this section apply, even though the transferee does not agree to assume or pay the indebtedness.

5. **Consider the tax implications of giving investment property.** If the donated property has been held for investment, the donor must also consider the implications of any depreciation taken on the property. By donating appreciated property, a donor may avoid the assessment of capital gain on the property since the charitable contribution is not considered a recognized event for capital gains tax purposes. However, for a property that was subject to accelerated depreciation that was previously deducted, the IRC has an anti-abuse requirement that requires recapture of depreciation as ordinary income.[14]

Opportunity—Maximize Tax Advantages from a Successful Gift of Real Estate

If Phineas donates his farm while it has $150,000 remaining on the mortgage, then his $600,000 contribution would be reduced to $450,000, and he would realize the $150,000 as gain. To maximize his tax benefits from this gift, Phineas should take one of the following two steps:

- **Satisfy the existing mortgage.** If he has the assets available, Phineas could pay off the $150,000 mortgage. This would allow him to be eligible to deduct the full $600,000 (subject to limitations).
- **Donate a remainder interest.** If Phineas wants to maintain an interest in the farm, he could donate

a remainder interest in the farm to charity while remaining liable for payment of the mortgage. This arrangement would be similar to a gift transaction already reviewed by the IRS.

In PLR 9329017, the taxpayer owned a farm with a $110,000 FMV and an $80,000 outstanding mortgage. As part of a charitable gift transaction, the taxpayer would donate the farm but remain liable for the mortgage. The taxpayer also proposed to make improvements to the property. The IRS ruled that because the property would be transferred subject to a mortgage, the transaction would be considered a bargain sale between the donor and the charity, resulting in a deduction equal to the present value of the charity's future interest in the $30,000 equity. The taxpayer would realize the entire amount of the indebtedness for purposes of determining gain under the bargain sale rules, not just the debt attributable to the remainder.

For Phineas, donating a remainder interest would make him eligible for a charitable deduction equal to the present value of the charity's future interest in the $450,000, but he would also have to realize the full amount of the $150,000 mortgage. Future mortgage payments would be eligible for additional charitable deductions.

Level Three: Giving While Protecting Finances

Life can change without warning. A donor may have a history of regular, significant charitable gifts, but if life suddenly throws a curveball, that donor may have to reevaluate priorities. In reaching level three of our game, we find our charitable explorer, Krisztina, seeking to minimize or even eliminate the impact of charitable giving on her current finances. What pitfalls must she avoid to reach her goal?

Pitfalls—Taxes and a Lack of Impact

In the midst of her latest world tour, after playing a palazzo concert in Venice, pop singer Krisztina learned that her younger sister, a single mother, had died in a car accident. Krisztina canceled the rest of her tour dates and returned home to care for her niece (8) and nephew (6). Shortly thereafter, Krisztina adopted her sister's children.

Since her rise to fame, Krisztina has made sizeable annual donations to her favorite charity. It meant a lot to her to be able to support a meaningful cause, and she wanted to continue giving, but she was now concerned for the children. The music business can be unforgiving, and Krisztina understands all too well that today's successful star can easily be tomorrow's judge (or, heaven forbid, contestant) on a reality show on a minor streaming service. Krisztina decides that the safest choice is to greatly reduce her giving or possibly stop giving entirely (at least for now). Before implementing her decision, she consults with her advisor and learns that she may be setting herself up for some pitfalls.

1. **A higher tax bill.** If she stops making charitable gifts, Krisztina will lose the charitable income tax deduction she is accustomed to claiming each year, and the assets she kept in her estate will be subject to estate tax. She may give less to the charity, but she will end up paying more to the IRS.
2. **A lower impact on a meaningful cause.** If she stops making charitable gifts—even if she believes it is the right course of action to ensure a comfortable life for the children—Krisztina knows she will feel disappointed in not making the same important impact on her favorite charity. The charity will miss her sizeable annual donations and may even struggle to continue its current programs, and she would hate to see that happen.

Opportunity—Give in a Way that Protects Current Finances

Krisztina's advisor suggests that her charitable giving doesn't have to be an all-or-nothing proposition—there are ways she can protect her financial interests while still helping others.

1. **A gift in a will or living trust.** Adding a gift to a will or living trust is an easy, flexible way for a donor to make an important future impact on a meaningful charity without impacting current assets. The donor may change or even revoke the gift at any point during life. The donor can also choose to set up the gift as a specific asset or amount, a percentage of the estate, or even what is left in the estate after all other obligations have been met.
2. **A charitable gift annuity (CGA).** This charitable giving tool provides a way to give *and* receive. It is a contractual agreement between the donor

and the charity under which the donor agrees to make a charitable gift and the charity agrees to pay a fixed amount periodically to one or two named beneficiaries.

3. **A charitable remainder trust (CRT).** This irrevocable trust provides another way to give and receive. The donor funds the trust, the trust pays out annual distributions to noncharitable beneficiaries for a specified period, and at the end of the trust term, the remaining trust assets are distributed to the designated qualified charity.
4. **A charitable lead trust (CLT).** This is essentially a mirror image of a CRT. The donor funds the trust, the trust pays out annual distributions to a qualified charity for a specified period, and at the end of the trust term, the remaining trust assets are distributed to the named noncharitable beneficiaries (often children or grandchildren).[15] This allows the charity to benefit immediately from the property while still allowing the grantor to direct the assets to an ultimate beneficiary.

In seeking financial security for her children (security that is independent of her future career) and a meaningful charitable impact, Krisztina chooses to use a blended gift—a combination of charitable gifts that provide the benefits she is looking for. Her blended gift consists of three parts:

1. **An immediate cash gift of $750,000.** She feels comfortable with this amount, given her current income and investments.
2. **A charitable lead trust of $10,000,000.** She works with the charity and her attorney to establish a CLT with her children as the remaindermen. The lead trust essentially makes annual gifts of trust income to the charity and will eventually pass the remaining assets to the children.

CLAT vs. CLUT

The charitable lead trust may be either a charitable lead annuity trust (CLAT) or a charitable lead unitrust (CLUT), with the difference being how the charitable income interest is paid.

A **charitable lead annuity trust** distributes a specified percentage of the initial trust assets as an annuity payment to the charity for the trust term.[16] The IRC provides that a CLAT must pay a sum certain at least annually to one or more qualified charities described in IRC §170(c), with the payment amount determined at the creation of the trust. The trust term is measured by a number of years (not to exceed 20) or by the life or lives of one or more individuals in existence when the trust is created.[17]

A **charitable lead unitrust** distributes a specified percentage of the trust assets as revalued each year.[18] The IRC provides that the CLUT instrument must pay at least annually a fixed percentage of the net fair market value of the trust assets as those assets are determined annually.[19] Generally, there must be no payments other than these income payments to charity until the trust terminates.

Krisztina works with her counsel to select and create a CLAT with a gift of $10 million for a 15-year period (to terminate when her nephew reaches age 21). The charity will receive an annual payout of 6% of the initial trust assets. The AFR used in the calculations is 5%. This results in the following:

Potential tax deduction for Krisztina:
$6,227,820

Annual charitable payment:
$600,000 (each year for 15 years)

Potential payout to the children:
$10,000,000 (assuming a 6% growth for trust assets)

3. **A gift in her will of $4,000,000.** This specific bequest is in addition to the substantial amounts that she has specified for her children and family.

In total, Krisztina's blended gift accomplished the following:

Immediate cash gift	$ 750,000
CLT (over 15 years)	$ 9,000,000
Bequest	$ 4,000,000
Total charitable impact	$ 13,750,000
Immediate cost to Krisztina (cash gift + CLT)	$ 10,750,000
Future potential return to the children	$ 10,000,000 (from the CLT)

By keeping her commitment to charitable giving while also providing for her newly adopted children, Krisztina accomplished both charitable and financial goals.

Boss Level/End Game: Does Avoiding Pitfalls Mean the Client Wins?

If Pitfall Harry avoids all the crocodiles, cobras, and quicksand and gets the treasure within 20 minutes, does he win? Yes and no—for Harry, the end of one game means the beginning of another. Harry's electronic existence will always be jumping, running, and trying to avoid the pitfalls. In real life, we often feel the same—constantly moving forward, dodging obstacles, trying to reach our goals.

Winning at human life can mean many things—love, success, learning, empathy, kindness, charity, family, creativity, and far too many others to list (perhaps even a Pepsi Free[20] now and then). Winning at financial, gift, and estate planning is easier to quantify—a client who is prepared and protected with expert advice will avoid the pitfalls and achieve their goals.

ENDNOTES

1 IRC §170(c).

2 IRC §§170(b)(1)(G), 170(b)(1)(A), and 170(b)(1)(F)(i) - (iii). NOTE: The 60% limitation is only available until December 31, 2025, and is then scheduled to revert back to 50%.

3 IRC §170(b)(1)(A). NOTE: There are two ways that an entity may be considered a publicly supported charity for purposes of IRC §170(b)(1)(A):

1. A charity that normally receives a substantial part of its support from governmental units and/or direct or indirect contributions from the general public. This support does not include income received in the exercise or performance of its tax-exempt purpose.

2. A charity that normally receives more than one-third of its support annually from any combination of gifts, grants, contributions, or membership fees and gross receipts from admissions, sales of merchandise, performance of services, or the furnishing of facilities in an activity which is not an unrelated trade or business, and normally receives not more than one-third of its support from gross investment income and net unrelated business taxable income.

4 IRC §170(b)(1)(G)(ii).

5 IRC §170(b).

6 Treas. Reg. §1.170A-13(a)(1).

7 Treas. Reg. §1.170A-13(c)(1)(i).

8 *McGuire v. Comm'r*, 44 T.C. 801 (1965).

9 IRC §170(e)(1)(A).

10 Ibid.

11 IRC §170(b)(1)(B)(i).

12 IRC §170(b)(1)(C)(iii).

13 Treas. Reg. §1.1011-2(a)(3).

14 IRC §1250.

15 IRC §664; IRC §170(f)(2)(B); Reg. §1.170A-6(c).

16 IRC §664(d)(1).

17 Ibid.

18 IRC §664(d)(2); Treas. Reg. §20.2055-2(e)(2)(vi)(a), and Treas. Reg. §20.2055-2(e)(2)(vii)(b).

19 Reg. §1.170A-6(c)(2)(ii)(A).

20 According to Wikipedia, Pepsi Free was phased out in 1987, with the modern version simply called Caffeine-Free Pepsi. https://en.wikipedia.org/wiki/Caffeine-Free_Pepsi.

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