

CHARITABLE PLANNING STRATEGIES

Numerous charitable gifting solutions are available, both during lifetime and at death, that provide significant tax benefits for the charitably inclined client. Qualifying testamentary charitable transfers are deductible in full for estate tax purposes to the extent that the property transferred is includable in the client's gross estate. If, instead, the transfer is made during the client's lifetime, it can qualify for a full gift tax charitable deduction as well as an income tax charitable deduction subject to the charitable deduction limitations of the Internal Revenue Code. The lifetime gift provides an income tax deduction that is not available for a testamentary gift, and can therefore be more advantageous to the client. However, the disadvantage to a lifetime charitable gift is that it must be irrevocable in order to save income taxes.

Charitable gifting options include outright gifts, gifts in the form of a charitable remainder trust, gifts to a Charitable Lead Trust, and gifts to private foundations. Typically, it is best to choose property that has appreciated in value since the appreciation in value of the property is not taxable to the estate owner even though the full fair market value of the property may be deductible for income taxes. However, extreme care must be exercised in selecting appreciated property since various rules limit the amount that is deductible by the donor. For example, appreciated ordinary income property that is gifted to charity will yield a deduction equal to the owner's basis rather than the fair market value of the property.

If the client is concerned about the lost value of the gift in their estate, the income tax savings generated by a lifetime gift can be used to purchase life insurance so that the diminution in the value of the estate is minimized. Ownership of the policy should be carefully arranged so that the estate owner has no incidents of ownership in the policy at their death and has made no transfers of the policy within three years of their death.

I. CHARITABLE REMAINDER TRUSTS—IRC § 644

Properly drafted Charitable Remainder Trusts (herein "CRT") provide numerous benefits to a client including a charitable income tax deduction, charitable estate tax deduction and avoidance of capital gains on the sale of the assets placed into the trust.

Clients have the opportunity to increase their return on investment since low-yielding appreciated assets can be sold without any tax on the appreciation and the proceeds can then be used to purchase higher-yielding assets or assets that produce tax-exempt income to further reduce the income tax consequences to the client.

CRT can also be an alternative to a qualified retirement plan through the use of a Net Income Makeup Trust. NIMCRUTS's are generally simpler to operate than retirement plans in the sense that there are no rules regarding highly compensated employees, there is no maximum limit on the amount that can be contributed to the CRT, and various other requirements under ERISA will not apply to the CRT.

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If a CRT plan is implemented, the client must decide whether to use a Charitable Remainder Unitrust (herein “CRUT”) or a Charitable Remainder Annuity Trust (herein “CRAT”). Numerous differences exist between a CRUT and a CRAT, which are detailed below.

Generally, a CRUT must provide for an annual payout to the estate owner, or another person named by the estate owner, of an amount equal to a fixed percentage of the trust assets valued annually. This percentage must be at least 5% and no more than 50% of the value of the trust assets. It is important to note that this payment must be made annually to the client and is based upon the principal of the trust on the valuation date, and not the investment performance of the assets.

Consequently, a CRUT can act as an inflation hedge if the assets produce more than the required payout as set forth by the trust. The trust may provide that income payouts be limited to the amount of actual trust income in any given year with the difference between the actual income and the required unitrust amount being made up in future years. In this manner, a CRUT can be used as a retirement plan by investing the trust assets in a way that does not yield income. This is commonly referred to as a net income makeup CRUT.

Beyond the requirements that the income payment must be at least 5% and no greater than 50%, Internal Revenue Code §§ 664(d)(2)(D) requires with respect to each transfer to the trust that at least 10% of the net fair market value of the property transferred to trust will eventually be paid to the charity.

Finally, only a CRUT can be used if the client wishes to transfer additional assets to the trust at a future date. This is different with a CRAT which, once it is created, cannot be funded with additional assets in later years. A CRAT is similar to a CRUT except that the annual payout is a specified sum which may be expressed as a stated dollar amount or a fractioned percentage of the initial net fair market value of the assets placed in trust. Later additions may not be made to a CRAT and it offers the estate owner no protection against inflation since the annual payout is a specified sum fixed at the inception of the trust. The advantage of the CRAT is that annual valuations of the assets are not required which may provide more flexibility in funding with assets that are not easily valued.

For both CRUTs and CRATs, the term of the trust can be either: 1) no longer than 20 years; or 2) the life/lives of the individuals to whom the assets of the trust are to be annually paid.

A. Example

- John Raider and his wife, Rachel, own appreciated stock valued at \$200,000.00 in which they have a \$50,000.00 basis. The stock yields 2% annually in dividends. Their objectives are to support Archbishop Rummel High School through a substantial gift, increase their income by moving from growth stocks to higher yielding investments, and provide for their children without increasing their taxable estate. John and Rachel donate the stock to a

charitable remainder unitrust paying them 6% of the value of the trust for life in quarterly installments.

- John and Rachel receive an income tax deduction for the present value of the charity's remainder interest. The deduction is affected by the age of the clients, the payout to the income beneficiary, and the frequency of payments. John and Rachel can deduct up to 50% of their adjusted gross income as a charitable income tax deduction for the gift. A five year carry over of the deduction is allowed.
- Capital gains will not be realized when the gift is made to the trust or if the asset is subsequently sold by the trust. If John and Rachel had instead sold that asset without using the trust, the amount available for reinvestment would be reduced by the tax on capital gains. Since the unitrust is a tax exempt entity, the trustee can sell the assets donated to the trust free of capital gains tax. Thus, the trustee can sell John and Rachel's stock and invest the proceeds in higher yielding, more diversified assets without reduction by capital gains tax. Further, John and Rachel's income increased from 2% to 6% of the amount invested.
- John and Rachel also achieve a gift tax deduction as the gift will be removed from their estate.
- Estate tax deduction. The property that passes to the charity will constitute a deduction and thereby save on any estate taxes that may be due in John and Rachel's estates.
- The tax savings or income from the unitrust can be used to purchase insurance on the life of donor the so that the donor's family members do not lose the wealth contributed to the trust. If the insurance policy is held in an insurance trust, the proceeds from the policy will not be subject to income or estate taxes. Thus, assets that would have been includable in the donor's estate are replaced by an asset that is not includable.

II. CHARITABLE LEAD TRUSTS—IRC §2055(E)(2)

In this form of planning, the charity receives an income interest in the trust for a certain term and, after the term expires, the property reverts to the donor or their family.

The gift and estate transfer taxes on the principal of the trust passing to the donor's family is reduced due to the fact that the charity will receive an income interest for a certain length of time, which reduces the value of the property that will eventually pass to the family members. Further, estate taxes on any appreciation in the value of the property after the trust is

established are eliminated if those assets pass to the client's children. Furthermore, to the extent that the client pays gift taxes on the transfer of the assets that will eventually benefit their family, the amount of dollars used to pay that tax will escape eventual estate tax if the client lives for more than 3 years after the transfer into trust.

To obtain a gift tax charitable deduction as well as possible income tax or estate tax deduction, the income interest payable to the charity must be in the form of a guaranteed annuity interest or a unitrust interest.

One primary drawback of a typical CLT is that generally, it will not generate an income tax deduction for the grantor. However, an income tax deduction can be obtained in the year that the trust is created with an income tax "defective" CLT if the grantor is willing to report all income earned by the trust without any offsetting deduction for the income that is paid to the charity. If the assets are invested in tax-exempt securities, the grantor can receive the income tax charitable deduction without later incurring the income tax liability of any earnings of the trust. Practically, the difficulty is obtaining a sufficient yield on tax-exempt securities to make the guaranteed payments to charity without unduly depleting the trust principal.

Example

- Sam places \$100,000 in a trust. Archbishop Rummel High School is to receive an annual payment of \$10,000 per year for 7 years. Sam holds the reversion and retains other powers. The reversion and the powers cause him to be treated as the owner of the trust. The interest rate used for the transfer is 8.0%. If the present value of Archbishop Rummel High School's annuity is \$52,064, Sam is allowed an income and gift tax deduction of \$52,064. The trade-off for this is that he is taxed on the trust's income each year.

III. DONOR-ADVISED FUNDS

Donor-Advised Funds are increasing in popularity due to their inexpensive and flexible nature. Donors can create these funds by contributing a minimum of \$10,000 in cash or assets to a public charity—called the sponsoring institution—that sponsors and creates the donor-advised fund. Qualified charitable 501(c)(3) charitable organizations, public charities, private operating foundations, and most religious organizations and educational institutions are eligible to receive a donation from a donor-advised fund. Donor-advised funds may be set up so that multiple charities benefit simultaneously.

Although the sponsoring organization has the final approval, donors provide recommendations regarding which organizations will benefit when the grants will be received, and the amount to be distributed. Sponsoring organizations differ as to how they administer the fund. This should be taken into consideration when selecting a sponsoring institution.

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Advantages of Donor-Advised Funds

Several tax benefits flow to the donor from the use of donor-advised funds, including an immediate income tax deduction of the fair market value of the asset, the avoidance of capital gains taxes if the gift is of appreciated property and, because the donor is divesting himself of assets, a reduction in the gross estate for Federal Estate Tax purposes. If the charitable contribution deduction exceeds the maximum amount that the taxpayer can deduct from their income taxes, any unused deduction can be carried over for five years. Additionally, the money will typically grow faster than if it were held in a different type of fund or account because the donor-advised fund is not subject to a yearly tax. Aside from the tax savings, donor-advised funds offer several other advantages.

In many circumstances, the use of donor-advised funds is a more affordable way to participate in charitable giving. Additionally, these funds are less complex, which will save the donor some legal and accounting fees. The fund is generally easy for the donor to administer since the sponsoring organization, rather than the donor, verifies the eligibility of charities. Flexibility is also one of the hallmarks of donor-advised funds. Donors may set aside decision-making for later if they are not ready to make a distribution. Donors also have the choice of attaching their name to the donation or remaining anonymous.

Private foundations may give their required 5% yearly distribution to a donor-advised fund if they have not yet decided on a specific charity. This is also a good system to use for yearly distributions from charitable remainder trusts and charitable lead trusts. Private foundations that wish to terminate may also roll their assets into a donor-advised fund.

Disadvantages of Donor-Advised Funds

Although the donor may make recommendations to the sponsoring organization regarding distributions to charities, the sponsoring organization is not required to follow these recommendations, so there is a possibility of loss of control. If the donor selects a valid charity, their recommendation will usually be followed; however, the client does not have ultimate control over the funds. Often, donor-advised funds that operate through a community foundation will restrict the amount of money that can be granted outside of the local area.

Many sponsoring organizations offer options for investments, but some do not give donors the choice. Additionally, donor-advised funds should not be used if the donor wants to collect income from the donated asset. In that case, a pooled-income fund or a charitable remainder trust is a better option.

Despite the lack of complexity in setting up donor-advised funds, the donor will likely incur management fees if they retain an advisor to manage the fund. Also, because the work associated with the fund is completed by the sponsoring organization, the donor lacks the ability to hire himself or his family to do the work. In a private foundation, on the other hand, donors can generally hire themselves or their family members to do the work.

IV. PRIVATE FOUNDATIONS

A tax-exempt private foundation is a corporation; community chest, fund, or foundation (including charitable trusts) organized and operated exclusively for one of the following purposes:

- Religion
- Charity
- Science
- Literacy or Education
- Promotion of Amateur Sports Competition
- Prevention of Cruelty to Children and Animals

The organizing document must limit the organization's purpose to one of the allowed objectives. The IRS has stated that a charitable purpose includes: relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.

The organizing document must not expressly authorize the organization to engage in activities, other than insubstantial activities, which do not further one or more of the accepted purposes. Additionally, the foundation may not benefit a private shareholder or individual. It generally cannot carry on propaganda, influence legislation, or support a political campaign. If the foundation meets the above requirements, it will generally be tax-exempt under IRC § 170.

Several types of entities, which seemingly qualify as private foundations, are excluded under IRC § 170(b) (1) (A). They include:

- Churches, or convention or association of churches;
- Educational organizations, such as schools and universities;
- Hospitals and medical research organizations;
- Organizations for the benefit of state and municipal colleges and universities; and
- Government units, including a State, the United States, a possession of the United States, a political subdivision, the District of Columbia, and Indian tribal governments

IRC § 170(b) (1) (F) describes three different types of private foundations:

1) a private operating foundation (as defined in IRC § 4942(j)(3)),

This type of entity is generally one that actively conducts charitable activities and makes qualifying distributions to carry out the foundation's

purpose or function. Such distributions must be the lesser of either the foundation's adjusted net income or its minimum investment return.

2) a conduit private foundation (as defined in IRC § 509(a)), and

Conduit private foundations must make qualifying distributions of 100% of the contributions received in order to qualify, meaning it cannot have any undistributed income remaining for the tax year. These distributions must be made no later than the 15th day of the third month after the end of the tax year in which contributions were received.

3) A common fund private foundation (as defined in IRC § 509(a) (3)).

A common fund private foundation arises when a public charity pools investments but maintains separate accounts for each contributor. The income and corpus will eventually benefit the public charity unless the donor designates some other public charity. Common fund private foundations are generally controlled in all other respects by the founding public charity.

Charitable contributions to private foundations result in income tax deductions to the donor under IRC § 170, provided that the aggregate of such contributions do not exceed 50% of the taxpayer's contribution base (approximately their adjusted gross income) for the taxable year. Gifts of capital assets to a private foundation are subject to a 30% limit of the donor's AGI if the sale of the property at the time it was donated would have produced a long-term capital gain.

The main benefit of contributions to private foundations is that it allows the donor increased control of his assets than if he had made the contribution directly to a charity. This is especially true when a donor establishes his own foundation and makes contributions. Serving on the foundation's board of directors and voting on how to distribute contributions will not negatively affect deductibility.

Donor-Advised Funds Compared to Private Foundations

The following chart illustrates the main differences between private foundations and donor-advised funds:

	Private Foundation	Donor-Advised Fund
Set-up Procedure	<ul style="list-style-type: none"> • Incorporate • Apply for IRS tax-exempt status 	<ul style="list-style-type: none"> • Simple agreement
Costs	<ul style="list-style-type: none"> • Substantial local and accounting fees at start-up • Contract or hire staff to perform financial and administrative services 	<ul style="list-style-type: none"> • No start-up costs • Sponsoring organization handles all financial and administrative services
Tax Issues	<ul style="list-style-type: none"> • File annual 990-PF tax return • Pay annual excise taxes typically of 1-2% of investment income • Cash contributions are deductible up to 30% of adjusted gross income (AGI) • Appreciated securities deductible up to 20% of AGI • Deductions are valued at cost basis except full appreciated value for publicly traded securities 	<ul style="list-style-type: none"> • Sponsoring organization handles all tax management • No excise taxes • Cash contributions are deductible up to 50% of AGI • Appreciated securities are deductible up to 30% of AGI • Deductions are valued at the full appreciated value
Grants	<ul style="list-style-type: none"> • Pay-out requirement is 5% of assets • Must verify the charitable status of recipient organizations 	<ul style="list-style-type: none"> • Distribution policies vary • Sponsoring organization verifies status of all recipient organizations
Control Issues	<ul style="list-style-type: none"> • Total control of distributions, provided it goes to a qualified organization • Has control over investment choices • More opportunities to showcase family legacy 	<ul style="list-style-type: none"> • Sponsor has final approval on all grants • Limited control over investment choices; depends on sponsoring organization • Opportunities to showcase family legacy dependant on sponsoring organization
Family Involvement	<ul style="list-style-type: none"> • Family members may work on all aspects of running a family foundation • Donor does not know how well the family will work together in the future (decades and centuries) 	<ul style="list-style-type: none"> • Family members can work on grant-making without worrying about administrative work • History of past-operations to rely on • Sponsoring organizations have procedures, staff, and board to

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		ensure ongoing quality
Family Perks	<ul style="list-style-type: none"> • Can be structured 	<ul style="list-style-type: none"> • None
Liability Insurance	<ul style="list-style-type: none"> • Must be purchased separately 	<ul style="list-style-type: none"> • Covered by the sponsoring organization
Privacy	<ul style="list-style-type: none"> • Tax returns on grants, investment fees, staff salaries, etc. are public records and are compiled into grant-seeker directories 	<ul style="list-style-type: none"> • Donors or grants may be kept private
Possible Problems	<ul style="list-style-type: none"> • More opportunities to violate rules or have conflict of interests 	<ul style="list-style-type: none"> • All responsibility for following the rules lies with the sponsoring organization
Wealth of Donor	<ul style="list-style-type: none"> • Better for donors with \$5 million or more 	<ul style="list-style-type: none"> • Better for donors with \$1 million or less

TMV Speeches-Charitable Planning Strategies

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