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The joy of charitable giving: Strategies and opportunities

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Executive summary. The tax benefits available through various charitable giving strategies can play a critical role in a potential donor's decision about which method to choose. Those who plan to make significant gifts naturally seek to pursue their philanthropic goals without harming their own financial security. Careful planning can help them to do so.

This paper outlines some practical options for making significant gifts. First, it can be more advantageous to donate during life rather than at death, because doing so offers both income tax and estate tax benefits. Second, choosing the right assets to donate can expand available tax benefits. For example, a gift of appreciated securities to a charity generally eliminates long-term capital gain recognition and also generates an income tax deduction. A gift of tax-deferred assets to a charity can minimize estate and income taxes for any heirs. Third, gifts can be made directly to a selected charity, private foundation, or donor-advised fund. The last option could give the donor and his or her family an immediate income tax deduction along with the flexibility to later identify the organization(s) they wish to support and the amount and timing of donations. Finally, the

current low level of the Section 7520 interest rate—used to value charitable trusts and annuities—can make these strategies more or less attractive. Of course, the particular method suitable for any individual will depend on his or her unique circumstances.[1]

People have many different reasons for charitable giving. Some choose to support personal values, such as specific interests or concerns about a legacy; some may give with a view toward tax and estate planning opportunities. There are many ways to give strategically—for example, by donating appreciated securities or tax-deferred assets, giving through a donor-advised fund or private foundation, or using methods such as trusts and annuities. Charitable giving is a highly personal decision, and it makes sense to discuss a plan with one's family and personal advisor.

Developing a vision

In developing a vision and plan for charitable giving, potential donors should focus on their philanthropic goals as well as overall wealth management. They may wish to consider how progress will be measured and success defined. Additionally, it is critically important to conduct due diligence on charitable organizations by researching and comparing their practices, administrative costs, and investment methods.

Giving must be viewed holistically within overall wealth management planning. For example, a donation made in a particularly high-income year (because of a large payout, sale of an asset, or simply converting a traditional IRA to a Roth IRA) will both fulfill personal charitable goals and reap substantial income and estate tax savings. Regardless of motivation, the donor must review the plan with a tax advisor.

Fundamentals

Nature of the income tax benefit

Generally, gifts to charitable organizations are tax deductible to the donor.[2] The amount of the tax benefit is based on the type of gift, the manner in which it is given, and to what type of organization it is given. In general, the donor's taxable income is reduced by the value of the gift. Therefore, the tax benefit of the gift is based on the donor's marginal income tax bracket. For example, if the donor was in the 39.6% income tax bracket[3] before and after the deduction, a $1,000 gift would reduce his or her tax liability by the amount of the gift x 39.6%, or $396 (Hammer and Shin, 2013).

1 This paper is not intended to and does not constitute legal or tax advice, and it cannot be used for the purpose of avoiding tax penalties that may be imposed under the Internal Revenue Code. The information in this paper pertains to federal tax law; state and local tax laws may vary. Because making significant charitable gifts can be complex, we recommend that you consult with your advisor to discuss your own situation.

2 See Internal Revenue Code §170(c).

3 Note that under the American Taxpayer Relief Act of 2012 (ATRA), the highest income tax bracket is 39.6%.

The amount of the tax deduction for charitable contributions is generally limited to 50% of adjusted gross income (AGI), and may be limited to 30% or 20% of AGI, depending on the type of property contributed and the type of organization to which it is given.[4] Generally, a taxpayer can carry forward his or her unused charitable deduction for a period of five years. Further charitable gifts made within the carryforward period may influence future deductions. Certain other requirements and limitations may apply. For example, in order to be eligible for the tax deduction, the gift must be made to a qualified charitable organization and must meet certain requirements set forth in the federal tax code. The allowable tax deduction will be reduced by the amount of any substantial benefit conferred upon the donor as a result of the gift.

If a donor makes a charitable gift of appreciated assets, in addition to the charitable income tax deduction, he or she will not recognize the long-term capital gain of such assets as long as they are given directly to the charitable organization. Similarly, if a donor, at death, leaves a tax-deferred asset (e.g., retirement accounts, annuities, etc.) to a charity, the amount given will generate a charitable estate tax deduction and the estate will not need to recognize as ordinary income the amount distributed from the tax-deferred account on its income tax return. Moreover, by giving a tax-deferred asset to a charitable organization, the donor may be able to leave more tax-advantageous assets to heirs (e.g., assets that do not inherently carry an income tax liability, such as retirement accounts) and thus allow the heirs to get a "step-up" in basis for those assets at the donor's death.

Nature of the estate and gift taxes

Whether a donor gives assets to a charity during lifetime or at death, the donor or his or her estate will be able to take a charitable deduction for gift taxes or estate taxes as the case may be. Unlike gifts or bequests to individuals, there is no limit as to how much a donor can give to a charitable organization free of the gift or estate tax, and the amounts so given do not affect his or her individual gift and estate tax exemption amounts (Shin and Hammer, 2013).

How much to give

After determining the charitable giving objective, the individual must determine how much to give away while simultaneously maintaining sufficient assets to support his or her lifestyle and retaining the desired amount of wealth to pass on to heirs. This is a personal decision and should be made after discussions with an advisor.

When to give

A charitable gift can be made during life or in the form of a bequest at death. As mentioned, from an estate planning perspective, it is generally better to donate during life. This creates not only an income tax deduction but also a corresponding gift tax deduction, and the removal of the gifted assets reduces exposure to estate taxes on death. A bequest, on the other hand, results only in an estate tax deduction.

4 See IRS Publication 526 (2011), *Charitable Contributions*.

With the exception of certain charitable trusts and annuities (discussed later), gifts made **during life** go directly to a charitable organization. Because these contributions are generally fully tax deductible, the larger the donation, the greater the tax benefit derived, as long as the deductions are itemized and gifts do not exceed the AGI limits.[5] A donor can also time a gift during life to attempt to maximize tax benefits, for example, by giving in years when he or she is in a higher income tax bracket.

A charitable gift after death, in the form of a **bequest**, is generally made through an individual's will or trust. Although charitable bequests provide only estate tax deductions, they offer some planning flexibility because they are revocable and can be modified during life. Plans for bequests should be regularly evaluated to ensure that family members will also receive financial resources consistent with the donor's desires.

Which to give: cash, appreciated assets, or tax-deferred assets

After quantifying how much is available to give, the donor should determine *which* assets to give. Different types offer different benefits. The simplest is a **cash gift**. The tax deductible amount is simply the amount of cash donated minus the value of any goods and services received in return. Cash gifts do not involve any transfer of stock certificates, titles, or other ownership documents. The donor can simply write a check to the charitable organization.

A second type of asset to consider is **appreciated marketable securities.**[6] If an individual donates marketable securities with long-term capital gains (that is, assets that have been held for more than one year), he or she may claim a tax deduction for their full fair market value (FMV). The donor also may avoid capital gains tax on the appreciation, which is generally the FMV minus the original cost basis of the asset. The charity can either hold the investment or sell it immediately without any tax impact. **Figure 1** demonstrates the benefits to a donor in the 39.6% tax bracket of giving to charity a stock purchased for $700 several years ago and now worth $1,000.[7]

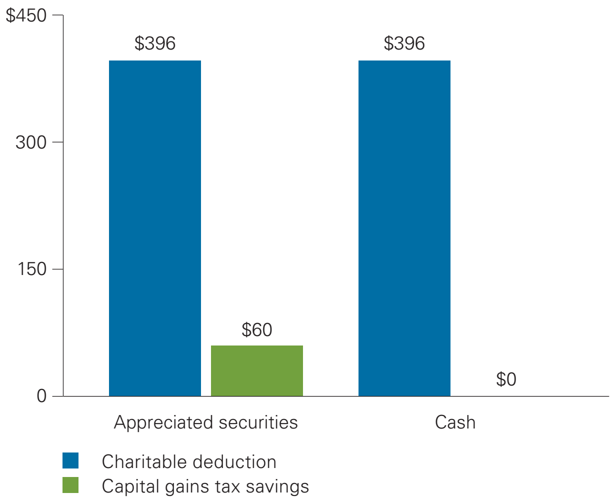
A third type of asset to give is **other appreciated investment assets** (such as real estate, artwork, or a hedge fund investment). As with appreciated marketable securities, this type of gift can generate substantial tax savings as well as avoid long-term capital gains taxes. Also, donation of these assets may simplify the administration of one's estate. If an individual wishes to donate this kind of asset, it would be prudent for him or her to discuss the gift with the charitable organization to ensure that the organization has the capacity to accept such a donation and is willing to do so. A qualified appraisal from a valuation professional may be required for tax purposes.

5 Generally, a taxpayer can carry forward an unused charitable deduction for a period of five years.

6 As a general rule, investments that carry a loss should not be donated to charity. In order to achieve the maximum possible tax benefit, an investor should sell them, use the loss to offset personal income tax or ordinary income, and donate the proceeds to charity.

7 Under the ATRA, a taxpayer in the 39.6% marginal income tax bracket is subject to 20% tax on long-term capital gains. The examples in this paper do not consider potential implications of the alternative minimum tax, the Medicare investment surtax, the Pease limitation on itemized deductions, or the personal exemption phase-out.

Figure 1. Tax benefits of donating appreciated securities versus cash



Notes: This example assumes a gift of $1,000 in appreciated securities or cash from a taxpayer in the 39.6% tax bracket. It assumes that the appreciated securities were purchased for $700 several years ago and are now worth $1,000, and thus have $300 of unrealized capital gain. It further assumes a 20% long-term capital gains rate. It does not take into account any potential effects of state and local tax, the alternative minimum tax, the Medicare investment surtax, or the Pease limitation on itemized deductions.

Sources: Vanguard, Internal Revenue Service.

The last general category is **tax-deferred assets** such as retirement accounts and annuities. These enjoy substantial income tax advantages during life, but at death they may have large remaining balances that could incur significant estate and income taxes. For example, when an individual passes away, an estate tax of 40% may be applied to the remaining balance. Moreover, when heirs begin withdrawing assets from these accounts, those withdrawals may be subject to income tax at the applicable federal income tax rates.[8] In addition, state and local income tax may apply. Therefore, the amount left to heirs may be significantly diminished after estate and income taxes. Payments from tax-deferred accounts to charitable organizations, on the other hand, are free from income and estate tax.

Thus, for those individuals who have both taxable and tax-deferred assets, strategically determining which will go to charitable organizations and which to individual heirs could be beneficial. Giving tax-deferred assets to a charitable organization can provide substantial benefits to the charity at low net cost to one's heirs. Giving taxable assets to heirs could result in little to no income tax because of the "step-up" in basis the heirs will receive as of the decedent's date of death.

8 Under current law, distributions from Roth IRAs should not be subject to federal income tax.

Figure 2. Comparison of gifts made to public charity, private foundation, or donor-advised fund

	Advantages	Disadvantages	Suitability
Direct gift to public charity	Simplicity; immediate benefit to charity.	Decisions to make direct gifts must be made and administered on an annual basis.	For those who would like to make an immediate gift to a specific charity.
Private foundation (PF)	Can maintain family involvement and control over administration, investments, management, and distributions; individuals may receive compensation and be reimbursed for services to the foundation.	Required to distribute 5% of its assets each year to charitable organizations; administration may be complex and must adhere to strict IRS rules, including "self-dealing" provisions; may incur excise tax on investment income; deductibility limitations are more restrictive than contributing directly to a public charity; a sizable amount should be donated to the foundation to cover startup and maintenance costs.	For those interested in exercising great control over their charitable gifts.
Donor-advised fund (DAF)	Easy to establish and maintain with an initial contribution; family members can participate in discussions about grants; treated as a public charity for tax deduction purposes; generally does not need to distribute account assets to charities each year.	Limited control over fund management and administration; may require minimum contributions to open and have minimum dollar levels for grants; may not be able to grant scholarships to or otherwise help individuals; advisors may not receive compensation.	For those who would like to avoid the cost and administrative burdens of a private foundation.

Source: Vanguard.

Direct gifts, private foundations, and donor-advised funds

Once the amounts, types of assets, and timing of the contributions are determined, a donor must select a charity. The three most common varieties are: (1) a public charitable organization, (2) a private, non-operating foundation,[9] and (3) a donor-advised fund.

A **direct gift** is a good way to make one-time or ongoing donations to specific organizations. Private, non-operating foundations and donor-advised funds, on the other hand, allow a donor to receive an immediate tax deduction while postponing the distribution of assets to a specific charity. **Figure 2** compares the advantages and disadvantages of the three methods. **Figure 3** compares the characteristics of a private foundation with those of a donor-advised fund.

9 A private, non-operating foundation is generally one whose primary program is grant-making, rather than running charitable programs.

Figure 3. Comparison of private foundation and donor-advised fund

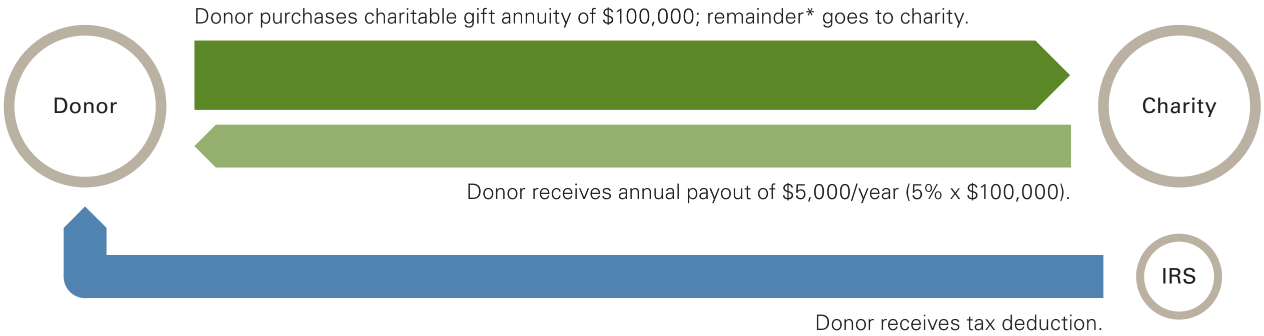
Features	Private foundation	Donor-advised fund
Initial setup costs	Typically at least several thousand dollars.	None.
Initial minimum funding amount	None, although usually individuals do not open a private foundation with less than several million dollars because of their ongoing legal and administrative costs.	Varies, but typically cash or securities totaling at least $25,000.
Excise tax	Generally about 1% or 2% of annual net investment income.	None.
Annual distributions	Generally requires 5% of net investment assets.	None, but periodic distributions are often required.
Operating costs and fees	Varies.	Varies.
Tax deduction	For new donations: up to 30% of AGI for cash gifts, up to 20% of AGI for publicly traded securities held more than one year.	For new donations: up to 50% of AGI for cash gifts, up to 30% of AGI for securities held more than one year.
Recognition or anonymity	Grants are a matter of public record.	Grants can be made anonymously.
Administration	Foundation handles grant research and reporting requirements.	DAF program staff may handle grant research and reporting requirements.
Grants to individuals	Permitted.	Not permitted.
Control of donated assets	Donor may retain control of donated assets.	Donor may not retain control of donated assets.

Source: Vanguard.

A **private, non-operating foundation** (PF) is a charity set up as either a corporation or a charitable trust. A PF applies for its own tax-exempt status and is typically administered directly by one or more people. It is generally responsible for its own tax filings with the government and is subject to more stringent regulatory and tax rules (see Figure 3). In addition, it usually must distribute to charitable organizations at least 5% of its assets annually. For a donor planning to make substantial gifts, establishing a private foundation can be a good way to get the family involved, particularly to support a cause important to them.

A **donor-advised fund** (DAF) is a public charity that allows an individual to donate money to a public charity (i.e., the donor-advised fund) and receive an immediate charitable tax deduction for the entire amount donated (subject to certain income tax limitations), even if those funds are not given to a charitable organization. The donor (or designated individuals) serves as the advisor to the account (particularly in regard to the investment of the assets). Over time, he or she makes recommendations as to which public charitable organizations should receive grants, when the grants should be made, and how much they should be (see Figure 3).

Figure 4. Charitable gift annuity



*Definition of remainder: The interest in assets that will be left to the charity after the life of the donor.

Source: Vanguard.

Annuities and trusts

Other options available to help donors reach both their philanthropic and estate planning goals include charitable gift annuities, split interest trusts, and many variations on these strategies. Individuals should work with an advisor to craft a plan to best meet their objectives.

Charitable gift annuities

One option for giving to a college or university is a charitable gift annuity. This is a contract whereby a donor, in exchange for a lump sum of cash, marketable securities, or other assets, receives a tax deduction and a fixed payment from the charity for life. The amount of the payment is established at the time of creation and depends on a number of factors, including the amount of the gift and the age of the donor at the time it was made. The property given to the charity is irrevocable and becomes part of the charity's assets, and the payments from the annuity are a general obligation of the charity, backed by the charity's entire assets (not just the property donated). Annuity payments continue for the lifetime of the donor. Many charities use payout rates defined by the American Council on Gift Annuities (ACGA).

When a donor creates a charitable gift annuity, he or she is deemed to make a charitable gift equal to the difference between the amount transferred in exchange for the annuity and the annuity's present value. Present value is determined using the **Section 7520 rate**, an interest rate set by the IRS and tied to the average market yield of U.S. obligations.

Figure 4 is a very simplified example of how a charitable gift annuity works. Suppose an individual purchases a $100,000 annuity with a payout rate of 5% per year. The annuity's annual income will be $5,000 per year for the remainder of the donor's life. Based on certain calculations, a portion of that income will be free from tax for the remaining life expectancy of the donor and another portion may be taxable at prevailing income tax rates. Because part of the $100,000 is considered a charitable gift, the donor will receive a charitable tax deduction in the current year.

Figure 5. Comparison of charitable lead trust and charitable remainder trust

	Advantages	Disadvantages	Suitability
Charitable lead trust (CLT)	Charity receives current income stream for a period of time; donor or designated heirs receive assets at termination of trust and can benefit from tax deduction or transfer wealth in a tax-efficient manner.	Requires annual administration of trust.	For financially secure individuals who wish to transfer wealth to heirs in a tax-efficient manner and provide current cash flow to a charitable organization.
Charitable remainder trust (CRT)	Donor generally receives current income stream and is able to diversify investments without incurring immediate recognition of capital gain.	Requires annual administration of trust.	For those who hold highly appreciated investments and would like to increase cash flow, diversify investments, and provide a remainder benefit to a charitable organization.

Source: Vanguard.

Split interest trusts

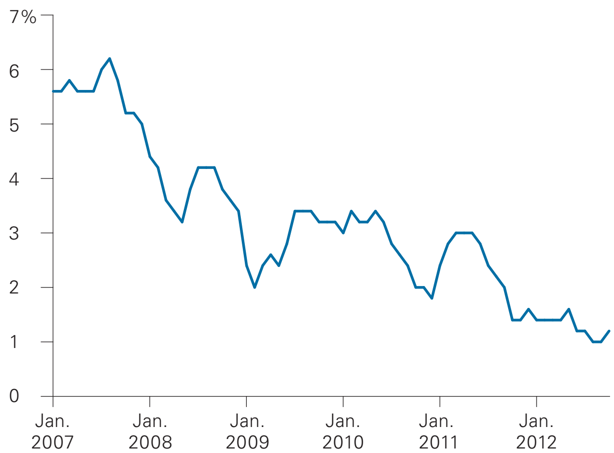
Generally, split interest trusts are trusts in which the ownership attributes of the assets have been split into two parts—an income interest and a remainder interest. There are two types of split interest trusts: "lead" trusts, in which the charitable organization is paid first, and "remainder" trusts, in which the charitable organization is paid last. Additionally, the payments from the trust can be either a fixed amount ("annuity" payments) or a percentage of principal ("unitrust" payments).[10]

A **charitable lead trust** (CLT, see **Figure 5**) is an irrevocable trust that the donor establishes by transferring assets into the trust and donating an income stream (i.e., an annuity or unitrust amount) from the assets to a charitable organization for a period of years. The donor designates the remainder interest (i.e., the assets remaining at the expiration of the period) in the trust to other beneficiaries (such as family members); it can be given outright or held in further trust for those beneficiaries. The donor receives an immediate gift tax deduction based on the actuarial value of the income stream to the charity. The donor could also receive a corresponding income tax deduction for the gift; however, he or she would need to recognize the income earned by the trust on his or her personal income tax return, even though a portion or all of the income is distributed to the charity.[11] For gift tax purposes, the value of the remainder interest (i.e., the taxable gift) is the difference between the total value of the gift and the actuarial value of the income stream to the charity.

10 See Internal Revenue Code §664.

11 Typically known as a grantor trust.

Figure 6. Historical 7520 rate, 2007–2012



Source: Internal Revenue Service.

The IRS uses the 7520 rate to measure two key components of the income and remainder interests of a CLT: the value of the charitable interest (for charitable tax deduction purposes) and the remainder interest passing to beneficiaries (for gift tax purposes). Because the 7520 rate is tied to the average market yield of obligations of the United States, it decreases as market yields decrease. As the 7520 rate decreases, the value of an annuity interest, for example, increases, and the corresponding charitable tax deduction increases. Thus, the current low interest rate environment, although challenging for some investment goals, is potentially advantageous for charitable lead trusts, because the value of the charitable gift is higher given the lower 7520 rate (see **Figure 6**).

Figure 7 illustrates the benefits of a charitable lead annuity trust (CLAT). Suppose a donor funds $1 million to a CLAT, with an annual annuity payout of 5%, or $50,000, to the charity. The term of the trust is ten years. The applicable 7520 rate is 2% and the assumed annual growth rate is 5%. Thus, the present value of the charity's interest in the trust and the amount of the donor's deduction is **$449,130**. The taxable amount of the gift to heirs is **$550,870** ($1 million – the charity's interest). The donor may or may not pay gift tax, depending on whether he or she has any gift tax exemption available. Regardless, the future value of the trust in ten years (less the stream of annuity payments for ten years) would be $1 million. Therefore, the donor will be able to transfer $1 million to his or her beneficiaries and use only $550,870 of the gift tax exemption.

A second type of charitable trust is a **charitable remainder trust** (CRT, see Figure 5 on page 9). In a CRT, the charitable organization is paid last, after individual beneficiaries have received a stream of income payments. The trust can be structured as a charitable remainder unitrust (CRUT), which pays a unitrust amount that fluctuates based on annual valuations of the trust. This type is typically used to provide, for a defined period of time, a stream of income either to the donor or to another beneficiary, allowing the donor to designate the ultimate charitable beneficiaries at the end of the trust term.

A CRT can also be structured as a charitable remainder annuity trust (CRAT), which could provide certainty for retirement planning purposes. This trust provides to the income beneficiary a fixed income stream determined as of the date of the gift to the CRAT; one or more charitable organizations receive the remaining assets when the trust terminates.

Figure 7. Value of a hypothetical charitable lead annuity trust

Funding amount to trust	$1,000,000
Annuity payout rate	5%
Payout frequency	Annual
Annual payment to charity (5%) *Funding amount to trust x annuity payout rate*	$50,000
Trust term	Ten years
Section 7520 rate (determined by the IRS)	2%
Annual growth rate in the trust	5%
Future value of trust in ten years	$1,000,000
Value of charity's interest	**$449,130**
Remainder interest to beneficiaries ***Funding amount to trust – value of charity's interest***	**$550,870**

Notes: The future value of the trust in ten years is calculated based on a 5% growth rate and a 5% annuity payment rate. The example assumes annual payment periods and ten total payments. It further assumes a term-certain annuity factor of 8.9826, which is used to calculate the charitable deduction (present value of annuity limited by Section 7520 regulations). The donor's deduction as a percentage of the amount transferred is thus 44.913%, or **$449,130**.

Source: Vanguard.

Regardless of whether a donor creates a CRUT or CRAT or some variation thereof, he or she can generally claim a charitable income tax deduction. Also, the donor may not have to pay immediate capital gains tax when the charitable remainder trust disposes of the appreciated assets and purchases other trust property.[12] The term of the trust may be based on lives or a term of years, and after the trust terminates, the charity receives whatever amount is left.

Figure 8. Value of a hypothetical charitable remainder unitrust

Funding amount to trust	$1,000,000
Annuity payout rate	5%
Payout frequency	Annual
Annual payment to grantor	5% of the CRUT valued annually
Trust term	Life of son
Section 7520 rate (determined by the IRS)	2%
Annual growth rate in the trust	5%
Value of son's income interest	**$654,870**
Remainder interest to charity	**$345,130**

Note: The example assumes a life remainder factor of 0.34513, which is used to calculate the present value of the remainder interest to charity.

Source: Vanguard.

Figure 8 illustrates the use of a CRUT. Suppose a donor funds $1 million to a CRUT when the 7520 rate is 2.0%. The trust is designed such that a 5% annual unitrust payout will be distributed to the donor's son for the remainder of the son's life. Assume the son is currently age 57 and the trust's annual growth rate is 5%. Under these terms, the donor's son will receive 5% of the trust's assets, valued annually, for the remainder of his life, and at his death, the remainder interest will be given to charity. As illustrated, the value of the stream of 5% unitrust payments to the son is $654,870, and the value of the charitable remainder interest is **$345,130**. The donor can claim an income tax deduction up to the value of this interest.

12 No deduction is allowed if it is determined that the terms of a trust will lead to a 5% or greater probability that the assets will be exhausted prior to termination of the trust. Revenue Ruling 77-374.

Conclusion

Potential donors can select from among many methods to achieve both charitable and overall wealth management goals. All of these opportunities should be explored with a personal advisor to develop a plan, keeping several points in mind. First, a gift made during life rather than at death generates both income tax benefits and estate tax benefits. Second, the types of assets donated offer various advantages. For example, gifts of appreciated assets can generally eliminate long-term capital gain recognition and generate an income tax deduction. Gifts of tax-deferred assets to a charity can minimize estate and income taxes for any heirs and generate a charitable deduction at low net cost to them. Third, gifts made to a private foundation or donor-advised fund allow for an immediate income tax deduction and give the donor the flexibility to later determine the timing of a direct grant to a charity. Finally, the current historically low level of the 7520 rate used to value the interests of trusts and annuities can make charitable lead trusts particularly attractive. Evaluating and weighing these options can help ensure that charitable giving meets both personal philanthropic and wealth management objectives.

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