Introduction

You could be a philanthropist. In fact, if you pay the maximum rate in federal income taxes, federal capital gains taxes, and federal estate taxes, you already are a philanthropist. An involuntary philanthropist. Each year your taxes go to causes and organizations selected by the federal government. Some of these causes you may care about, and others you may not even know exist.

Wouldn't it be nice to be able to direct your tax dollars to the nonprofit organizations that you like to support? Can you imagine the IRS accepting a note with your tax return requesting they send your tax dollars to your children’s school for computers? Even though you cannot give the IRS these specific directions, you can control that portion of your wealth - your social capital - that you cannot keep. Because most people don’t know they can control it, by default they send it to the IRS in the form of taxes. The knowledge that you can actually redirect these tax dollars to organizations of your choosing opens the world of philanthropy to all taxpayers. It takes you from being an involuntary philanthropist - a taxpayer - to becoming a voluntary philanthropist.

Using your social capital, you can contribute to your religious institutions, your children’s schools or your alma mater. You can help fund a cure for a disease that has touched your family or help make it possible for abused children to have a safe place to grow up. In fact, you can direct your social capital to wherever you feel it will do the most good. The current tax system actually encourages you to make it possible for abused children to have a safe place to grow up. The knowledge that you can actually redirect these tax dollars to organizations of your choosing opens the world of philanthropy to all taxpayers. It takes you from being an involuntary philanthropist - a taxpayer - to becoming a voluntary philanthropist.

This Special Report will introduce you to five of the most popular charitable giving strategies, ranging from the simple (outright gifts) to the complex (charitable trusts and private foundations). By implementing one or more of these strategies, you too can become a voluntary philanthropist instead of an involuntary one. As you will see, charitable planning does not have to be hazardous to your wealth!

LEVEL ONE

OUTRIGHT GIFTS

The simplest form of charitable giving is an outright gift to charity. An individual need only select the organizations to which he/she wishes to make donations and either transfer the property during life (and receive an income tax and gift tax deduction) or make a specific gift in his/her will or revocable trust (and receive an estate tax deduction). Subject to certain limitations noted below, an income tax deduction is allowed for contributions to charity, whether in the form of money or “property”. No deduction is allowed, however, for the contribution of services (i.e., volunteer work).

Income Tax Deductibility Limitations

The deductibility of charitable contributions for income tax purposes is subject to two types of limitations: percentage limitations and valuation limitations.

Percentage Limitations

Percentage limitations pertain to the amount that an individual may claim as a charitable deduction against his/her gross income in any tax year. In general, the maximum amount that an individual may claim as a charitable contribution deduction in a given year is 50% of his/her adjusted gross income (“AGI”) without regard to any net operating loss carry-back for the year (the “contribution base”). The 50% limitation is available only for direct contributions to public charities, private operating foundations and conduit foundations. Deductions for contributions to other types of charitable organizations (primarily private nonoperating foundations) are limited to 30% of the individual’s contribution base.

The foregoing percentage limitations apply only to contributions of cash and ordinary income property (i.e., property which, if sold, would not result in long-term gain). Gifts of property held by the donor for more than one year (i.e., capital gain property) to a public charity are deductible up to 30% of the donor’s contribution base. However, the donor can increase the limit to 50% of his/her contribution base by electing to step down (reduce) the amount for which he/she is claiming a deduction by the amount of the long-term gain that would have been taxable had he/she sold the contributed property at its fair market value. This option will be attractive to donors of capital gain property that has not produced significant gains. Gifts of capital gain property to a private non-operating foundation are deductible up to 20% of the donor’s contribution base.

Charitable deductions exceeding the foregoing percentage limitations can be “carried forward” and used during the five years following the contribution. Charitable deductions carried forward are subject to the same limitations.

Valuation Limitations

The valuation limitations pertain to the value of the asset contributed for income tax deduction purposes. If the contribution is in the form of stock or other non-cash assets, the deduction may be limited to the taxpayer’s income tax basis in the contributed asset, rather than the fair market value of the asset.

♦ Ordinary Income Property. With respect to ordinary income property, the amount of the contribution for which an individual may claim a charitable deduction generally is limited to the contributed property’s cost, not its fair market value. Such limitation applies regardless of the identity of the donee (i.e., whether the donee is a public charity or a private foundation).

♦ Capital Gain Property. Capital gain property donated to a public charity is deductible up to the property’s fair market value. However, a gift of such property to a private foundation is deductible only up to the donor’s income tax basis in the property.
5. Give appreciated long-term capital gain property to charity (e.g.,

6. Purchase life insurance inside an irrevocable life insurance trust (ILIT) so that the death benefit passes to the donor’s family income and estate tax free. The life insurance proceeds will “replace” the wealth passing to charity, thereby allowing the donor to make an immediate or deferred gift of land, stock, or other property, while still providing the desired family inheritance.

7. Qualified and non-qualified retirement plans are one of the best assets to give to charity because they are exceptionally inefficient in passing wealth on to heirs. This is due to the fact that they face both income and estate tax, in some cases leaving only about 20% to 30% of the assets in the plan for the participant’s heirs. Many participants choose to leave their retirement plans directly to charity and then use life insurance as a way to “replace” the plan assets for their heirs. Another option that may be considered is taking a distribution from the qualified plan and using it to purchase a life insurance policy in an irrevocable trust. The donor can then give the remaining plan assets to charity at his/her death. Not only does the charity receive a gift, but the donor’s heirs may receive more than they would have if the participant attempted to pass the retirement plan assets directly to them.

8. A charitable remainder trust (CRT) is an especially powerful tool for those who have highly-appreciated assets and a desire for increased income (see Level 3 below). These assets are often non-income producing land or low-yield stocks. A life insurance policy equal to the original gift to the CRT, but owned in an irrevocable trust, allows the heirs to receive the full value of the assets without paying estate taxes. Properly structured, the premium can often be paid with the income generated from the tax deduction and/or a portion of the excess income which results from the avoidance of the capital gains tax using a CRT.

9. Use life insurance as a funding asset inside a CRT (i) to substantially increase the remainder value of the trust, thus providing a larger gift to the donor’s selected charities when the trust terminates, (ii) to “balloon” trust corpus when the first income beneficiary dies, creating a much larger income payout for the surviving income beneficiary, and/or (iii) to make partially tax-deductible premium payments for a personal insurance need.

10. Purchasing life insurance for estate liquidity has been a standard life insurance technique for many years. Another technique, however, has been gaining increased attention in recent years as a more exciting way to control assets: The “Zero Estate Tax Plan.” Properly structured, this technique can allow the donor to leave his/her gross estate to his/her heirs without estate taxes, and assure that his/her heirs will become actively involved in philanthropy, thus passing on family values as well as family wealth.

LEVEL THREE
CHARITABLE REMAINDER TRUSTS

A charitable remainder trust (“CRT”) is an irrevocable trust (inter vivos or testamentary) that pays a stated amount each year to one or more individuals for a specified term of years (not exceeding 20), or for the life or lives of the individual or individuals. In general, a CRT must designate one or more specific charitable remaindermen. However, the grantor or another person can have the power to change or add to the charities named as remaindermen without jeopardizing the charitable deduction.
Types of CRTs

There are two general types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT).

**CRATs.** A CRAT pays a fixed annuity to the non-charitable beneficiaries. The annuity must be at least 5% of the initial fair market value of the trust.

**CRUTs.** A CRUT pays the stated amount in the form of a unitrust interest rather than an annuity. That is, the CRUT pays the non-charitable beneficiaries a fixed percentage (at least 5%) of the value of the trust assets, determined annually. Thus, trust distributions from a CRUT vary from year to year, depending on the value of the trust property.

A CRUT is often thought of as a way to protect the non-charitable beneficiary’s cash flow from the effects of inflation. As the trust increases in value, the unitrust payments increase, reducing or offsetting the effect of inflation on the purchasing power of the distributions. However, there is no guarantee that the value of the trust property will increase, and any decrease in value will result in a smaller unitrust payment.

**CRUT Variations**

- **Net Income Charitable Remainder Unitrust (NICRUT).** A NICRUT pays the non-charitable beneficiary the lesser of the net income realized by the trust or the unitrust amount.

- **Net Income Makeup Charitable Remainder Unitrust (NIMCRUT).** Like a NICRUT, a NIMCRUT pays the noncharitable beneficiary the lesser of the trust’s net income and the unitrust amount, but in those years in which the net income exceeds the unitrust amount, additional payments are made to “make up” for any prior years in which the unitrust amount was not fully paid due to insufficient income. A deferred annuity contract may be purchased by a NIMCRUT, thereby providing the donor with a current income tax deduction and deferring receipt of the unitrust payments until such time as the donor needs income and is in a lower income tax bracket (e.g., at retirement). Such a strategy would essentially allow a person to fund, on a partially tax-deductible basis, a personal pension plan that is not subject to annual contribution limits.

- **Flip Unitrust.** The flip unitrust is a NIMCRUT or NIMCRUT that, upon a triggering event or date specified in the trust instrument, changes to a “straight” CRUT. The flip unitrust is ideal for taxpayers who ultimately want the unitrust amount to be computed on the fixed percentage method, but initially fund the trust with unmarketable assets that will generate little annual income until they are sold.

**Pay-out Limitations**

The following rules will limit the permissible annual pay-out from a CRT:

- **10% Remainder Rule.** The present value of the charitable interest must be at least equal to 10% of the initial fair market value of the trust property.

- **Maximum Pay-out.** A CRT may not have an annual pay-out greater than 50% of the value of the trust property.

- **Exhaustion Test.** If the probability exceeds 5% that the CRT will be exhausted before anything is paid to the charitable remaindermen, no gift or estate tax deduction is available.

Income Taxation of Payments to Non-Charitable Beneficiaries

The payments from a CRT during the noncharitable term will be taxed to the recipient as follows:

- First, as ordinary income to the extent of the CRT’s ordinary income for the year and undistributed income for previous years.

- Second, as capital gain to the extent of the CRT’s capital gain for the year and undistributed capital gain for previous years.

- Third, as other income (including tax exempt income) to the extent of such income of the CRT for the year and such undistributed income for previous years.

- Last, as a distribution of trust principal.

**Income Tax Treatment**

- **Income Tax Deduction.** Upon creation of an inter vivos CRT, the grantor receives an income tax charitable deduction equal to the present value of the remainder interest, subject to the percentage limitations discussed above. If the charitable remaindermen can be changed by the grantor or anyone else, and the grantor wants the percentage limitations for contributions to public charities to apply for income tax purposes, the power to designate new charitable remaindermen must be limited to public charities.

**Gift and Estate Tax Treatment**

Upon creation of a CRT, the grantor makes a gift or bequest of the annuity or unitrust interest to the non-charitable beneficiary (unless the grantor is the only non-charitable beneficiary), and a gift or bequest of the remainder interest to charity which qualifies for the gift or estate tax charitable deduction.

**LEVEL FOUR CHARITABLE LEAD TRUSTS**

A charitable lead annuity trust (“CLAT”) is a trust that pays a fixed annuity to one or more charitable organizations for a term of years, for the life or lives of an individual or individuals living when the trust is created, or for the life or lives of an individual or individuals living when the trust is created plus a term of years. At the end of the period, the remaining trust property is distributed to, or held in trust for, the remaindermen (e.g., the grantor’s descendants).

The trustee may be given discretion to determine which charities will receive the annuity payment each year, or the trust agreement can specify the charities. A CLAT may be created during life, or under a will or revocable trust to take effect at death. The annuity may be payable to the grantor’s own private foundation. However, the bylaws and articles of the foundation would have to be amended in order to preclude the grantor from participating in any decisions regarding the management or disbursement of the funds received from the CLAT; otherwise, the CLAT property will be includible in the grantor’s gross estate.

**Gift and Estate Tax Consequences**

Upon creating the CLAT, the grantor makes a gift or bequest to charity of the present value of the charity’s right to receive the annuity payments. As a “guaranteed annuity”, this gift or bequest qualifies for the federal gift or estate tax charitable deduction. At the same time, the grantor makes a taxable gift or bequest of the remainder interest to the remaindermen. The value of the gift or bequest to the remaindermen is equal to the value of the property transferred to the CLAT less the value of the charitable annuity interest.
Income Tax Consequences

♦ Non-Grantor Trusts. If the CLAT is a nongrantor trust, the grantor will not receive an income tax charitable deduction upon its creation. However, the CLAT receives unlimited income tax charitable deductions for amounts paid for charitable purposes from its gross income (which includes capital gains), and it is not subject to the percentage of gross income limitations on charitable deductions imposed on individuals. To the extent the CLAT’s gross income exceeds its charitable contributions in any given year, such excess income will be subject to income tax at the trust level, and the unused charitable deduction cannot be carried over to succeeding years.

♦ Grantor Trusts. If the CLAT is a grantor trust, the grantor is entitled to an income tax charitable deduction in the taxable year in which the CLAT is created equal to the present value of the annuity interest. Because contributions to a CLAT are treated as “for the use of” the charitable donees, the deduction will be limited to 30% of the grantor’s adjusted gross income (or 20% if long-term capital gain property is used to fund the CLAT). However, the income of the CLAT will thereafter be taxable to the grantor, with no further charitable deduction to the grantor or the CLAT allowed, even though the CLAT actually distributes income to charity.

Benefits of CLATs

The benefits produced by CLATs are twofold: (i) charitable benefits, and (ii) estate planning benefits.

♦ Charitable Benefits. If the grantor makes annual contributions to charity, a CLAT could be used to make those contributions on his/her behalf while possibly providing a benefit to his/her children. In addition, if the grantor’s annual charitable gifts exceed the amount he may deduct on his/her personal income tax return due to deduction limitations, a CLAT could be used to satisfy the portion of these charitable gifts and thereby obtain the benefit of an income tax deduction for the remaindermen (presumably the grantors’ children). Of course, the grantor would have to weigh the cost of giving up his/her current income tax deduction as well (unless a grantor CLAT is used).

♦ Estate Planning Benefits. A CLAT can serve to transfer property free of gift and estate tax to the grantor’s children.

Benefits of CLUTs

A charitable lead unitrust (“CLUT”) is identical to a CLAT, except that instead of paying a fixed annuity, the trust pays to charity a fixed percentage of the fair market value of the trust property, as determined annually. Distributions from a CLUT can vary from year to year, depending on the value of the trust property. As with a CLAT, the transfer of property to a CLUT constitutes a gift to the remaindermen equal to the total value of the property transferred to the trust, less the value of the unitrust interest (which qualifies for a gift tax charitable deduction). CLUTs are typically preferable to CLATs when the remaindermen are to be the grantor’s grandchildren, or trusts for their benefit, and later generations.

LEVEL FIVE
PRIVATE FOUNDATIONS

To provide maximum control and flexibility, a donor can form a private foundation to be the recipient of any one or more of the four types of charitable gifts described above. In other words, a private foundation (i) can be the recipient of outright gifts or bequests, (ii) can own life insurance, (iii) can be a CRT remainder beneficiary, and/or (iv) can be a CLAT or CLUT “lead” beneficiary.

A private foundation itself is a privately funded charitable organization that either makes grants to public charities or actively conducts substantial charitable activities of its own. A private foundation may be in the form of a trust or a non-profit corporation, although the corporate form is generally the most flexible.

Making a gift to a private foundation has the following advantages:

♦ The donor receives an immediate income tax deduction, and the contributed property may be reinvested and disbursed to public charities over time.

♦ A private foundation, other than a private operating foundation, need only make annual distributions to public charities equal to 5% of its net investment assets. Therefore, with good investment results, the foundation grows in value.

♦ The board of directors of a private foundation may consist entirely of family members, and the bylaws can provide one or more board members with a controlling vote.

♦ The foundation’s charitable purposes need not be tied to the needs of any particular charity, but can be as broad or limited as specified in the bylaws (which may be amended by the board).

♦ A private foundation may compensate and reimburse its board and officers for personal services that are reasonable and necessary to carrying out its exempt purpose as long as the compensation or reimbursement is not excessive.

♦ A foundation can perpetuate the donor’s family name so that the donor’s family would be recognized and appreciated for its generosity.

♦ A foundation can be used as a means to develop and reinforce family unity through regular meetings, informal discussions and decision-making processes.

CONCLUSION

Giarmarco, Mullins & Horton, P.C. has established a national reputation for innovation and expertise in the planned giving area. Our approach with clients is to help them define their objectives in the following three areas: (1) financial independence – the amount needed to maintain their desired lifestyle; (2) family legacy - the desired inheritance for family members; and (3) social capital legacy - the remainder of the estate which will be used for society’s needs either through estate taxes or charitable gifts. By using one or more of the planning strategies described in this Special Report, we afford our clients the opportunity to redirect tax dollars from the IRS to charity, and give them the satisfaction of controlling the allocation of their assets between themselves, their heirs and society.

For more information on this Special Report, please e-mail your requests to Salvatore J. LaMendola at sjl@disinherit-irs.com or call Sal at (248) 457-7204

This Special Report is designed to provide accurate (at the time of printing) and authoritative information with regard to the subject matter covered. It must not be used as the basis for legal or tax advice. In specific cases, the parties involved must always seek out and rely on the counsel of their own advisors. Thus, responsibility for modifying and guiding any party’s action with respect to legal and tax matters is placed where it belongs - with his or her own advisors.