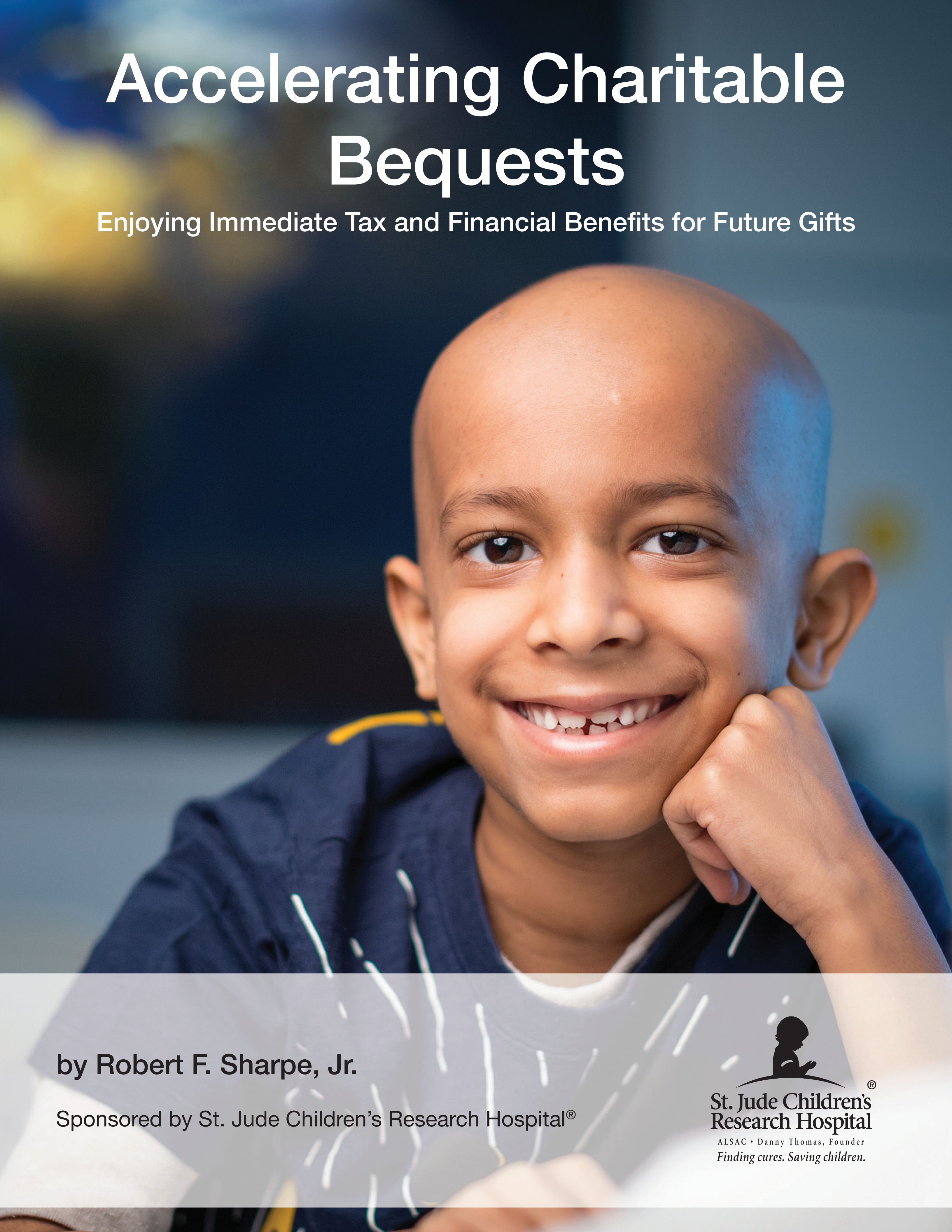
Accelerating Charitable Bequests

Enjoying Immediate Tax and Financial Benefits for Future Gifts



by Robert F. Sharpe, Jr.

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INTRODUCTION

Over the last few years, the estate and financial planning community has adjusted its use of various planning tools and techniques to reflect the reality of significantly higher exemptions from federal estate taxes, beginning in 2011. This trend can be expected to continue in the wake of 2017 tax legislation that increased the gift and estate tax exemption amounts to an estimated $11.2 million per person.

For 2016, the most recent year that both Internal Revenue Service and national death statistics are available, some 2.6 million Americans passed away. Of that group, just 4,144 estates were valued at more than $10 million. This means that 99.8 percent of decedents in 2016 would not be subject to federal transfer taxes if they had passed away in 2018. While 19 states and the District of Columbia impose estate or inheritance taxes, just 38 percent of Americans live in these jurisdictions. The states that do not impose such taxes include a number of highly populous ones, such as California, Florida and Texas.

NON-TAX MOTIVATIONS

According to Giving USA, the total bequest giving of $30.4 billion in 2016 was the fourth highest total on record as Americans have continued to include charitable provisions in their estates despite a major reduction in tax incentives to do so.

As a result of new tax planning realities estate and financial planners will increasingly need to consider the non-tax motivations that have always, in reality, been of great importance for those considering bequests through their estates.

Family members, close friends, associates and charities are the primary entities found in wills or other estate plans. When someone includes a charity in an estate plan, she’s, in effect, elevating that charity to the status of a family member. This inclusion typically requires a great deal of donative intent.

But, does this mean that philanthropically inclined individuals should disregard tax considerations when they decide the most effective ways to make gifts at death? No, but planners should consider taking a broader view of a client’s overall tax situation when planning these charitable gifts.

In many cases, it may appropriate to broaden the discussion with the client to include income tax issues and other concerns, such as the desire to protect assets, provide income for himself and/or loved ones and enjoy other financial benefits that can result from careful charitable gift planning.

Let’s look at some of the benefits of making special charitable gifts in ways other than traditional bequests through wills, trusts and other testamentary planning vehicles. There are a number of ways a client might consider “accelerating” charitable bequests.

LIFE INCOME GIFTS

Charitable individuals will often hesitate to make larger gifts they would like to make. The reasons they don't make these gifts typically involve a number of common concerns, including fears that they'll die before taking care of loved ones; outlive their resources; or suffer a costly illness or other economic reversal.

Fortunately, there are many planning tools that make these seemingly impossible gifts possible. In many cases, tax laws also result in immediate tax benefits that can largely "replace" estate tax savings that no longer exist, given higher estate tax thresholds.

Consider the case of Arthur. He's a childless widower, age 79, with $5 million in assets. He's planning to leave $4 million to his nieces and nephews and the remainder of his estate, estimated at $1 million, in equal shares to two charitable interests—one that he's supported over time and the other to his late wife's favorite charity. Given the estimated federal estate tax threshold of $11.2 million for 2018, this $1 million bequest would result in no federal estate tax savings.

Arthur owns securities worth $500,000 with a cost basis of $150,000. These securities pay dividends of just 1 percent, or $5,000 per year. If he sold the securities and reinvested the proceeds he could owe capital gains taxes of as much as $52,500 at the federal level. State capital gains tax might also be due.

CHARITABLE REMAINDER UNITRUST

What alternatives might he consider? If he were to fund a 5 percent charitable remainder unitrust (CRUT) using the appreciated securities, his income would increase from $5,000 to $25,000 the first year, with the possibility that it could grow with the value of trust assets over time. No capital gains tax would be due at the time he funds the trust, and the trust, as a tax-exempt entity, won't be liable for tax on future capital gains or on its undistributed ordinary income.

Given his age and current federal discount rate of 2.8 percent, Arthur would be entitled to an immediate charitable income tax deduction equal to 66 percent of the value of the securities transferred to the CRUT, or $332,000. In his 24 percent tax bracket, this alternative could save him nearly $90,000 in federal and state income taxes. He can make use of the deduction for the year of the gift and as many as five future years if the amount exceeds what he can immediately deduct.

From Arthur's perspective, he's increased his spendable income without incurring capital gains taxes, while enjoying capital gains and income tax savings that could exceed $140,000 over time.

While he can no longer access the funds in the trust, these assets are also beyond the reach of creditors or individuals who might take advantage of him in later years. The charity that's the remainder beneficiary will enjoy the knowledge that it will benefit from the remainder of the trust and will receive the funds without experiencing the expense and delay of probate.

Another aspect of interest to Arthur's asset managers is the ability to diversify the assets on a tax-free basis inside the trust and continue to actively manage the assets for the remainder of Arthur's life.

FIXED INCOME ALTERNATIVES

Suppose Arthur is also interested in arranging for a source of fixed income for the remainder of his lifetime. In this case, he might also decide to transfer $500,000 in low yielding cash to his other charitable interest to fund a charitable gift annuity (CGA) that would make annual fixed payments to him of 6.4 percent, or $32,000, for the remainder of his lifetime. Depending on a number of factors, he might instead choose to fund a charitable remainder annuity trust (CRAT) that would make payments of the same or a similar amount. This option would allow these funds to continue to be managed by his current advisors.

Whether in the form of a CGA or CRAT paying 6.6 percent, this gift would result in a charitable deduction of over 50 percent of the gift amount, or $251,400. While he may not be able to use a deduction of this size in addition to the deduction for the CRUT, if he chose the CGA option, some 84 percent of his annual payments would be received tax-free as return of his investment in the contract for a period of his life expectancy of 9.9 years. Income from a CGA may be taxed more favorably than a CRAT in the near term, while the CRAT may be the better option if he lives beyond his life expectancy.

In any event, through the combination of these two types of gifts he would enjoy a balance between a higher fixed income from the gift annuity or CRAT and a source of income that can grow over time with the performance of assets in his CRUT.

Through the funding of these two gifts, each charity has the knowledge that it's the irrevocable beneficiary of a gift that will result in eventual benefits in the range of $500,000, depending on the performance of the trust assets and the underlying gift annuity reserve fund.

In each case, the funds aren't subject to expenses over time that could reduce the amount of a residuary bequest if Arthur continued with his current plan to leave the funds in the form of a bequest via his will or other testamentary vehicle.

It's also possible that Arthur may decide in the future that he no longer needs the income from the life income gifts he's established. In this case, he could decide to give up his right to all or a portion of his remaining income interests and allow his gifts to fully or partially come to fruition during his lifetime. He'd then enjoy additional tax savings through deducting the value of the remaining income interest he's foregone.

ENDOWMENTS

Along the same lines, Arthur might decide to use a portion of his payments each year to begin funding an endowment. In a variation on a “virtual endowment,” he might give a portion of his $57,000 in additional income each year to start his endowments during his lifetime. This commitment could be made revocable, so that he makes this decision on a year-by-year basis.

For example, if the charities would eventually spend 4 percent of the combined $1 million in endowment, or $40,000 per year, Arthur could give a portion of his additional income each year toward making that spending an immediate reality. He’d report the income each year, but it would be offset by a corresponding charitable deduction subject to any normal deduction limits.

Finally, it’s not unusual for donors who may have made a bequest commitment to a charitable interest at a younger age (when they had many years ahead of them and worried about outliving resources, for example), to decide in later years that they can actually afford to make an outright gift.

In Arthur’s case, he and his deceased spouse may have each made $500,000 bequest commitments during campaigns conducted by their charitable interests 15 years ago when they were in their mid-60s. Now that he’s 79 and has survived his wife, he may decide to make an immediate $500,000 pledge to each of the charities involved and pay $100,000 toward each pledge annually for five years.

This pledge would reduce his estate by $1 million over time, assuming his remaining assets didn’t grow, but at his age, he could reasonably assume that the remaining $4 million would be sufficient to see him through the remainder of his lifetime. From a tax planning perspective, Arthur would realize as much as $240,000 in tax savings over the 5-year period of the pledge payments.

CONCLUSION

These are just a few of the ways Arthur might choose to “accelerate” his charitable bequest to provide him with significant tax and other financial benefits, while also putting the eventual charitable recipients potentially in a better position with a more predictable gift expectancy.

In today’s environment of higher income and capital gains taxes and lower transfer taxes at death, we believe the time may right for many charitably inclined individuals to consider ways to structure gifts that provide greater benefits to all concerned.

ABOUT ST. JUDE

St. Jude Children's Research Hospital is leading the way the world understands, treats and defeats childhood cancer and other life-threatening diseases. It is the only National Cancer Institute-designated Comprehensive Cancer Center devoted solely to children. Treatments invented at St. Jude have helped push the overall childhood cancer survival rate from 20 percent to 80 percent since the hospital opened more than 50 years ago. St. Jude is working to drive the overall survival rate for childhood cancer to 90 percent, and we won't stop until no child dies from cancer. St. Jude freely shares the discoveries it makes, and every child saved at St. Jude means doctors and scientists worldwide can use that knowledge to save thousands more children. Families never receive a bill from St. Jude for treatment, travel, housing or food – because all a family should worry about is helping their child live.

ABOUT ROBERT F. SHARPE, JR.

Robert is chairman of the philanthropy editorial board of *Trusts & Estates* magazine. He has served on the board of Giving USA and has served on strategic task forces for the Partnership for Philanthropic Planning (PPP) and co-authored the PPP Model Standards of Gift Valuation. He has chaired the annual Council for Advancement and Support of Education (CASE) conference on Structuring Major Gifts since 2004. He currently serves on the Congressional legislative advisory council for the Alliance for Charitable Reform.

Robert has authored many articles and his remarks have been featured in the *Wall Street Journal*, *The New York Times*, *Newsweek*, *Forbes*, *Smart Money*, *The Chronicle of Philanthropy*, *Trusts & Estates*, *Kiplinger's* and other national publications. He is a frequent speaker for professional gatherings across the country.

With over 35 years of experience serving America's nonprofit community, Robert Sharpe is a nationally recognized pioneer, leader, and authority in the field of philanthropy. As Chairman of the Sharpe Group, he consults with educational, health, social service, and religious organizations and institutions in implementing and improving their major, planned gift, and endowment development efforts. With offices in Memphis, Atlanta, Washington, DC and San Francisco, the Sharpe Group has worked with over 10,000 nonprofits nationwide during its 52-year history.

He earned degrees with honors at Vanderbilt University and Cornell Law School. In past years, he served as a development officer at a liberal arts college and practiced law with a major law firm specializing in income, estate, and gift taxation and corporate planning.