

# BOELTER & ASSOCIATES

## FACT SHEET

### ESTATE PLANNING USING CHARITABLE TRUSTS AND FOUNDATIONS

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#### BACKGROUND

Gifts to charities fulfill philanthropic desires and have income and estate tax benefits. With proper planning clients can save taxes and fulfill their philanthropic desires. The Tax Relief Act of 2001 potentially reduced both the income tax benefits and the estate tax benefits of charitable gifts. First, the income tax benefits are potentially reduced because the individual income tax brackets are reduced thus making the tax deduction less valuable. The estate tax benefits may also be reduced (or eliminated) because the applicable exclusion amount increases until 2009 at which point \$3.5 million will be excludable from estate taxes. Then in 2010, the estate tax will be repealed altogether. Unfortunately, under the Tax Relief Act-2001, the applicable exclusion amount will return to \$1 million on January 1, 2011. The most conservative approach to planning is to assume that the applicable exclusion amount will be \$1 million. This is the approach here.

If you want to leave part of your estate to charity, there are many strategies available that you can use to provide funds to your favorite charities while also providing estate and income tax benefits. These strategies range from the simple strategy of outright gifts to some very complex strategies that utilize specialized trusts. A list of qualified (nonreligious) charities is available from the Internal Revenue Service (IRS) Publication 78 entitled "Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code."

#### OUTRIGHT GIFTS TO CHARITIES

The most common way to donate to charities is through outright gifts, for example, writing a check or donating items of clothing or other property. People make mistakes when donating assets to charities. Once you have decided to make a donation to a charitable organization, you want to maximize the benefit to both you and the charity.

##### Gifts of Cash

Here you typically write a check or give cash. For contributions in excess of \$250, you must receive and maintain a written acknowledgment from the charity. The advantages of this type of gift is its simplicity and full tax deductibility, as well as the fact that you have removed the asset from your estate. However, you create very little leverage. You have a dollar, you give a dollar you receive a dollar tax deduction. It may be preferable for you to donate some asset other than cash.

##### Gifts of Property

The types of property that you can give are as varied as the types of property you own. For example, you might own an old car that is in excellent condition but has little resale value. You may not want the car, but it may be of value to a charity. We note in passing that there is presently little or no tax value in giving a car to a charity.

If you give property such as real estate or securities, not only do you remove the asset from your estate, but you also remove the future growth of that asset from your estate. The actual transfer of your property to your selected charity can take some time. If you are giving securities that are held in a brokerage account, usually the simplest way to complete the transfer is to have your charity open an account at the same brokerage firm. You can then write your broker a letter and have him or her transfer your selected securities over to the charity's account. For real property or tangible personal property, you need to have the deed or title transferred into the name of the charity.

### **Gifts of Appreciated Property**

The best way to create leverage through outright gifts is by giving away appreciated property. Example: A makes a \$12,000 pledge to his church's building campaign. The question is whether to write a check for this amount or to donate the \$12,000 worth of Coca Cola stock that he acquired 15 years ago for \$2,000. A had planned to hold his stock as part of his long-term investment program. A believes the stock will continue to be a good investment in the future. What should A do? Answer: Give away the stock. If A had to sell the stock now, perhaps because of an emergency, he would incur substantial capital gains tax. If A gives it to his church, he will receive a deduction for its full market value (\$12,000). If he wants to maintain the stock for long-term investment, he can simply buy the stock using the \$12,000 cash he had planned to give to his church. The result of these transactions is that A now owns \$12,000 worth of Coca Cola stock with a \$12,000 cost basis. Because the church is treated as a charity for tax purposes, when the charity sells the stock A gave it, it is a nontaxable event.

Gifts of appreciated securities and real estate are by far the most effective way to make outright gifts. Note though: to receive a deduction for fair market value on gifts of tangible property, the gift must be one usable to the charity as part of the charity's purpose. For example, the gift of a car or tractor to your church would likely only qualify for a deduction based on your cost basis in the car or tractor because it is not something that your church normally uses as part of its operations.

## **GIFTS TO PUBLIC FOUNDATIONS**

Assume that you have numerous charities that you would like to help. However, the transfer process described previously would be too burdensome for small contributions. Transfers would also not work if you may want a deduction in this calendar year but are undecided on the amount of your donations and what charities. Two excellent alternatives are: (1) the private foundation; or (2) a donor advised fund of a public foundation. Taxpayers are allowed to make gifts to foundations in cash, securities, or property and receive an immediate tax deduction. The foundation then holds the assets until the taxpayer gives them instructions on the disposition of the property to the charities chosen. Most of the public foundations can even provide information as to the worthiness of charities that you may be considering. For this service, you are charged a small fee that is usually based on a percentage of your contribution.

### **Tax Deduction Limitations on Outright Gifts**

Generally, a taxpayer will receive a full tax deduction for gifts totaling up to 50 percent of his/her adjusted gross income (AGI) during any calendar years. If the gift is to a nonpublic charity, the deduction is restricted to 30 percent of the taxpayer's AGI. Gifts in excess of these amounts can be carried forward for up to five years. Note: there is also a limitation on itemized deductions that must be considered, and amounts disallowed by the itemized deduction rule are *not* eligible for carryover.

## TESTAMENTARY GIFTS TO CHARITIES

People often make specific bequests to charities in their will. However, a taxpayer can create more tax leverage by making the donation while alive. If you intend to give a certain piece of property worth \$100,000 to charity and leave it to the charity in your will, there will be no estate taxes on the gift. However, if you give it to charity while you are alive, you not only remove it from your estate for estate tax purposes, but you also received a current income tax deduction worth \$30,000 to \$40,000.

### Gifts Using Charitable Trusts

Significantly greater benefits than outright gifts can be had through the use of charitable trusts. These trusts can be structured to achieve a variety of personal and charitable objectives. For example, one can convert highly appreciated non-income-producing property into income-producing property while avoiding large capital gains taxes by using a *charitable remainder trust* (CRT). Alternatively, a charity can receive a stream of income from assets while the property remains in the family with a *charitable lead trust* (CLT). Finally, you can leave a lasting legacy of charitable giving for your heirs by establishing a *private foundation*.

### Charitable Remainder Annuity Trust

The charitable remainder annuity trust (CRAT) is an ideal vehicle for taking appreciated non-income producing property and converting it into assets that can provide you or a family member with current income. Assume X is age 55 and owns land that is currently valued at \$900,000. X's cost basis in the property is \$90,000. X is considering an early retirement but would need to convert assets to produce an income stream. One alternative is to sell the property and invest the proceeds in income-producing assets such as government bonds. The results of the sale would be as follows:

Step 1: Determine the Tax  
\$900,000 Current value of land  
-\$90,000 Cost basis of land  
\$810,000 Taxable gain  
x 0.15 Capital gains tax rate  
\$121,500 Capital gains tax

Step 2: Determine the Income  
\$900,000 Proceeds from sale  
-\$121,500 Capital gains taxes  
\$778,500 Available to reinvest  
x 0.06 Expected earning (6 percent)  
\$46,710 Income earned annually

If instead, X uses a CRAT, here is how it would work. Assume that X would like to leave assets to his alma mater. X would decide what interest rate he would like to receive and whom he would like to act as his trustee. In this case, X chooses 6 percent and elects to serve as trustee. X transfers the deed from X as an individual to X as trustee. Once the property is transferred, the trustee sells it for \$900,000. Because it is a charitable trust, there are no taxes on the proceeds. X then place the entire sum in investments of his choosing. As trustee, X has full discretion over investment decisions. Because X elected a 6 percent payout, X will withdraw \$54,000 annually for as long as X lives. Not only does X increase his annual income, but X also receives an income tax deduction of \$329,000.

There are two issues with this strategy: X's spouse and X's children. To resolve the spousal issue, X would set the trust up so that the income is paid over *both* lives. As long as either spouse is living, the trust will continue to pay \$54,000 per year. The only thing this adjustment affects is the initial tax deduction. If, for example, X's spouse were age 52, the tax deduction would be reduced to \$238,900.

As to X's children, there is a more challenging problem. Perhaps the best solution would be to take the tax savings dollars and purchase a survivorship life insurance policy on X's life and his spouse. The policy should be purchased using an irrevocable insurance trust. If X's children are adults, an alternative would be to have them be the owner and beneficiary of the policy with X gifting them the cash to pay the premiums. Table 1 illustrates a \$900,000 survivorship life insurance policy.

### The Wealth Transfer Effect

Under the previous scenario, the goal was to convert a non-income producing asset into one that produces income. This satisfies an income need, but what about your estate planning goals? You have removed the asset from your estate by way of the charitable trust and can use part of the tax savings to buy life insurance, which will be received by your children income and estate tax free.

As you can see, the intelligent use of a charitable trust can be extremely beneficial. You receive more income during your lifetime; your children benefit because they receive a large inheritance; and the charity (your alma mater) benefits because it receives a larger sum than it would have likely received under other circumstances.

**Table 1: Survivorship Life Insurance\***

\$900,000 (Level Death Benefit) with Annual Premium of \$4,945		
Year	Cash Value	Death Benefit
1	\$1,400	\$900,000
10	\$50,000	\$900,000
20	\$159,000	\$900,000
30	\$317,000	\$900,000
40	\$411,500	\$900,000
*Male, age 55; female, age 52		

### Charitable Remainder Unitrust

Under the CRAT, what you receive is a fixed income that does not ever change. What about inflation? The *charitable remainder unitrust* (CRUT) addresses the issue of inflation.

Structurally, the CRUT is set up similarly to the CRAT. The settlor establishes the trust and transfer property into it. As trustee, you then sell the property and reinvest the proceeds as you wish. You receive an income from the trust during your lifetime, and at your death, the remaining assets go the charity of your choice. The income can be paid over the joint lives of you and your spouse if you so desire. What differs is how the income is figured. With a CRUT, you set an interest rate for purposes of calculating the amount of withdrawal that is due each year. Although the interest rate never changes, the amount of dollars received fluctuates based on the changing value of the account each year. For instance, in the earlier example, X contributes \$900,000 of real estate to the charitable trust, and from then on received \$54,000 (6 percent) per year. The income amount never changed. Under a CRUT, X would receive 6 percent of the value of the account as of a certain date each year. If the account value increased to \$1,000,000 in the second year, a 6 percent distribution would produce \$60,000. This results in a growing income if the total account value grows. The opposite is also true. If the account values decrease, so will the distributions. Also, the Federal discount tables used to calculate income tax deduction results in a smaller deduction per dollar of contribution. Taking our same example as before and using a joint life payout for X and his spouse, the deduction under a CRAT would be \$238,900 versus \$167,200 for the CRUT. Because the account values of a CRUT must be determined each year, it is not an appropriate trust in which to place hard to value assets such as a closely held business interest.

## USING YOUR CHARITABLE TRUST FOR RETIREMENT PLANNING

If you are currently employed, you are probably concerned about retirement planning. While you're still working and earning a good salary, you should make the most of your earnings. If you are fortunate enough to have an employer-provided retirement plan, then part of the job may be done for you. Many employer plans are of the 401(k) variety. These plans are very helpful but are rarely sufficient to fully fund one's retirement. One way to supplement your retirement income is by establishing a CRUT that contains specialized provisions. A CRUT allows *annual* contributions, whereas a CRAT does not. This can be accomplished by modifying the trust agreement with two special provisions:

- (1) Add language that says that if the trust income is not sufficient to pay the percentage elected, that the trustee will pay the *actual* income the trust produces. For example, X elects a 6 percent annual income distribution. The trust investments, however, only produce 1 percent income. The result is that only 1 percent is distributed to X. Note that this is a period of time in which the taxpayer do not need additional income. The taxpayers are still in their most productive earning years, and his goal is to store up assets for retirement. So,...
- (2) The trust is set up to include a catch-up provision. This says that any income the taxpayer is owed but not distributed will be distributed to the taxpayer when additional trust income is available.

Accordingly, the initial trust investments will include assets that produce little or no income. This allows you to store income for the future. Once you are ready to retire, you sell these investments and reinvest the proceeds in high-income investments such as corporate bonds and CDs. The result is that your account achieves maximum growth during your working years and then is switched to maximum income during your retirement years. Any excess income earned by the

trust can be paid out as part of the catch-up provision. Note: The sale of the appreciated securities does not result in any taxes because of the trust's tax-exempt status.

**Example:** Assume that H and W are age 40 and 42 and would like to supplement their retirement program by investing \$30,000 per year. They would also like to benefit their favorite charity, the American Cancer Society. H and W decide to establish a CRUT with a 6 percent payout and a make-up provision. They contribute \$30,000 each January and invest in a diversified portfolio of growth stocks that pay little or no dividends. As it turns out, the portfolio earns an average rate of return of 12 percent to H's age 65. This results in the account growing to \$4,480,000! H and W now sell all the growth stocks and invest in long-term corporate bonds with average yields of 8.5 percent. As H and W now begin taking income, the trust agreement allows for a 6 percent payout or \$268,801, and the make-up provision now allows them to take the excess earnings as well. This extra 2.5 percent excess income amounts to an additional \$112,000,, bring the total annual income to \$380,801. H and W are allowed to continue to take the excess income distributions until all prior deficits have been exhausted. Note: Each time H and W make a contribution, they are receiving a partial tax deduction as well. The trust can be set-up so that the income is paid over both H's life and the life of W or just H's life.

### **Pooled Income Funds**

One disadvantage of the charitable remainder trust is the cost involved in setting up the trust. It can cost several thousands of dollars to set one up then there will also be annual maintenance costs. Your trustee must obtain a taxpayer identification number and file annual tax returns. There is also the matter of trustee duties. Your trustee (often you) is legally a fiduciary to the trust and is required to follow certain rules and procedures. Failure to do so can result in legal liability. An alternative is the pooled income fund.

With a pooled income fund, the charity prepares all the documents and administers the fund for you (typically at no cost). You contribute property to the fund and receive *interest income units* during your lifetime or a specified period of time. Your deduction is calculated in the same manner as with the charitable remainder trust. This type of trust has several advantages over the charitable remainder trust, as well as some disadvantages.

#### Advantages

- The charity has undertaken the costs of establishing the trust and bears the ongoing costs of administration.
- The charity hires professional managers to invest fund assets which relieves you of that responsibility.

#### Disadvantages

- Because the trust has been established by the charity, there is no opportunity to customize the document to your specific needs. You are also likely to encounter less flexibility in determining your income as well as how the investments will be structured
- All income from a pooled income fund is considered ordinary income and is therefore taxed at your highest marginal tax rate. Income from a charitable remainder trust uses a

tiered rate system that allows long-term capital gains and/or tax-exempt income to flow through to you.

In general then, the pooled income fund is more appropriate in cases where the intended gift is less than \$100,000. The size of this gift would make a charitable remainder trust impractical because of both the initial and ongoing costs.

### **Charitable Lead Trust**

With a charitable lead trust, the charity receives the income from the trust for a specified period of time, and the remainder interest then reverts to someone the taxpayer designates (typically a child). This type of trust works well if the following are true:

1. The taxpayer owns income-producing property but does not need the income or the asset.
2. The taxpayer wants to divert the income to a charity for a period of time.
3. The taxpayer would ultimately like to transfer the asset to a family member but pay little or no gift or estate taxes.

This trust can be set up as either an *inter vivos* (during your lifetime) trust or a *testamentary* (under your will) trust.

#### Advantages

1. The primary advantage of the charitable lead trust is the transfer of a large asset to your children at significantly reduced gift tax costs.
2. You remove the assets from your estate, and also remove *any growth* on that asset from your estate.
3. Contributions to a charitable lead trust are unlimited, whereas contributions to charitable remainder trusts limit your deduction to 50 percent of AGI (30 percent for nonpublic charities).

#### Disadvantages

1. Contributions to a charitable lead trust provide you with a gift tax deduction rather than an income tax deduction unless the trust is set up as a grantor trust. The rules regarding *grantor charitable lead trust* will tend to reduce the effectiveness of wealth transfers to your children.
2. Trust income is taxed to the trust to the extent that it exceeds the income paid to the charity. For example, if you set your trust up to pay 6 percent annually to the designated charity, but the trust income is actually 7 percent, the excess 1 percent will be taxed directly to the trust. In the case of a grantor trust, excess income will be taxed to the grantor.
3. Capital gains are not a tax-free event as they are with a charitable remainder trust. If the trustee sells an appreciated asset, the gain will be taxed to the trust. Therefore, you will

want to contribute assets that you have no intention of selling or that are not likely to appreciate in value.

4. When the trust ends and the remaining assets revert to your children, this is considered a gift of a future interest and therefore does not qualify for your annual gift tax exclusion. You must either pay the gift taxes or use part of your lifetime applicable, exclusion amount. Also, there are legal costs for setting up this trust, annual accounting costs for maintaining the trust, and duties that must be carried out by the trustee.

### **The Private Foundation**

A private foundation can create a perpetual legacy of charitable giving for your descendants while accomplishing significant estate planning objectives for yourself. With a private foundation, you are, in effect, establishing your own tax-exempt organization for the purpose of benefiting charities, educational institutions, and/or religious organizations. Then, either during your life or at your death (under your will), you contribute money or property to your foundation. The income tax deduction during your lifetime is limited to 30 percent of your AGI. You may act as the trustee and designate family members as successor trustees. The trustees can be paid a reasonable income from the trust for their services. It is an excellent strategy but there are numerous pitfalls.

#### Advantages

1. Lifetime gifts to your private foundation generate an income tax deduction within certain limitations
2. Your foundation can create a lasting memorial to your family in much the same way as Bill and Melinda Gates.
3. You can use your foundation to aid a specific cause, such as child abuse, or you can provide your trustees broad discretion in deciding how to disperse charitable contributions.
4. Your lineal descendants can be the trustees. This creates a lasting legacy of charitable giving for your heirs. It places them in a position of prominence in charitable circles. As trustees, they can receive reasonable income for their services.
5. Assets contributed to your private foundation are removed from your estate and thus avoid estate taxes.

#### Disadvantages

1. A private foundation is a complex legal document. The costs of establishing one and maintaining it are relatively high. In addition to annual tax filing requirements, there are federal reporting requirements. Many states also impose reporting requirements. A private foundation is, therefore, more appropriate for large contributions. Many advisors suggest a minimum of \$100,000 as an appropriate initial contribution.
2. The people you would like to act as trustees, typically your children, may lack the investment management skills or general management skills to run the trust. They may also lack the interest. The trustees are fiduciaries and, as such, are responsible for their

actions. Violations of fiduciary responsibilities can result in personal liability for a trustee.

3. Private foundations are required to distribute at least 5 percent of the trust each year. The trustee must make certain that there is sufficient liquidity for this purpose.
4. The federal government imposes a 1 percent excise tax on private foundation income (increased to 2 percent in certain cases).
5. Over the years, Congress has switched back and forth regarding the extent of the deduction for transfers of appreciated assets to a private foundation. Sometimes the deduction is for the full market value of the gift, and other times only your original cost is deductible. For gifts during your lifetime, check with us to determine the deduction you will receive. This will not affect gifts under your will because all assets receive a stepped-cost basis at death with the exception of 2010, when the Tax Relief Act-2001 repeals stepped-up cost basis.

### Example

H and W have a taxable estate of \$5,000,000, which places them in the 47 percent estate tax bracket. Three million dollars of their estate is comprised of retirement plan assets, and the balance is made up of family farm property, which is both something they would like to keep in the family and is highly illiquid. To pay their estate taxes their heirs will need to use the money from the retirement plan. We examine the estate and income tax impact on the retirement plan at the last of the couple to die:

\$5,000,000 Taxable estate  
- \$930,000 Estate taxes (assuming two credits)  
- \$400,000 Income taxes on retirement plan distributions  
\$3,670,000 Net to heirs from taxable estate

In order to pay the taxes, the H&W heirs will need to liquidate over \$1.5 million of H's retirement plan. This is a problem as the sale of retirement plan assets to pay estate taxes will trigger *income taxes*.

Assume however, H & W decide to establish a private foundation that they name "the H & W Family Foundation." They contribute their entire \$3 million retirement plan to their foundation. They elect to have their children serve as trustees and give their children the right to elect their own successor trustees, presumably *their* children.

\$5,000,000 Taxable estate  
- \$3,000,000 Gift to private foundation  
\$2,000,000 Taxable estate\*  
- \$0 Estate taxes (assume two credits)  
- \$0 Income taxes  
\$2,000,000 Net to heirs

\*The taxable estate is reduced by the \$3 million charitable contribution.

There are no taxes due because H & W are each able to use their lifetime exclusion amount. The private foundation trust agreement allows the trustees (the children in this case) to receive reasonable management fees for their services as trustees. The children will receive some income plus the pleasure of giving money to worthy charitable causes. In order to avoid the problem of a reduced estate available to the children, H & W establish an irrevocable life insurance trust and place \$1,300,000 of survivorship life insurance in it. As a result, when they die, the children receive \$1,300,000 of life insurance income and estate tax free, \$2,000,000 of property, plus management fees for acting as trustees of their family private foundation. The family foundation has \$3,000,000, and, if it is managed well, it will grow in size and provide future descendants the opportunity to continue the family tradition of charitable giving. To pay for the survivorship life policy H & W will make annual gifts to their children who will in turn own and pay the policy premiums. Based on the parents age (both are age 53), the annual premiums will be approximately \$7,000 per year, which the H & W pay for from current cash flow.