FUNDAMENTALS OF PLANNED GIVING

PART TWO: BASIC PLANNED GIVING METHODS

PG CALC WEBINAR

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INTRODUCTION

No doubt the simplest and most straightforward gift is an outright contribution for the unrestricted use of the charitable organization … preferably in cash. However, there are a great number of other ways in which a contribution can be made. Some charitable gift plans can provide an income or stream of payments to the donor or others. Some allow significantly greater tax advantages than a simple outright contribution. Others can allow a donor to meld complex financial and estate planning goals with charitable objectives.

Why pursue these alternatives, especially given all their added complexity? First, the charity will provide a valuable service to its most loyal donors by working with them to create charitable gift plans that meet the donors' needs as well as those of the organization. In addition, by offering the full range of charitable giving opportunities the organization will appeal to a much wider audience. Finally, other charitable organizations will offer alternatives and so, if only as a matter of keeping current, your charitable organization should be familiar with these more sophisticated methods of charitable giving.

TESTAMENTARY GIFTS

A testamentary charitable gift is simply a formal direction or instruction to transfer money, property, or other assets to a charity at death. The testamentary gift is usually made by executing a formal legal instrument during lifetime. Typical tools for making testamentary gifts include charitable bequest provisions in Wills and trusts as well as beneficiary designations on all manner of financial instruments and accounts.

What is the appeal of testamentary charitable giving?

For the donor there is an intuitive appeal. A testamentary contribution is a logical extension of one's lifetime accomplishments and ambitions. It is a way to make a final statement about one's visions and beliefs. Testamentary giving also provides the donor with an opportunity to accommodate various contingencies and conditions specific to his or her circumstances. Finally, a testamentary gift, unlike other kinds of charitable gifts, preserves flexibility for the donor in that it can be modified, or deleted completely, if the need arises.

Testamentary gifts appeal to charitable organizations because they provide an opportunity to seek support for long-term needs without disrupting fundraising for current needs. In addition, testamentary gifts provide an opportunity to identify and address entirely new groups of constituents. Even those who are either maximizing their current giving or who are unable or unwilling to give currently can be asked to consider a testamentary gift. Indeed, testamentary gifts can be a key prospecting and cultivation step in pursuit of further gifts of all kinds.

Finally, there is a large potential audience for testamentary giving. According to research conducted by the Partnership for Philanthropic Planning less than 8% of the population has included a charitable bequest in their estate plans. And, of those who have, only one in four has notified the charity of their plans.

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The Probate Process

Prior to considering specific types of testamentary contributions, we will first briefly review "probate," the process by which an estate is administered and settled. Although the term "probate" has specific legal meaning, it is frequently used by non-lawyers to describe all of the steps and processes involved in gathering, administering, and distributing an estate following the death of an individual.

The rules governing estate administration vary from state to state, and the process is usually carried out under some level of court supervision. In broad strokes, these are the steps that must be taken to settle and distribute an estate:

1. The Executor (the one responsible for managing and administering the estate) must locate the Will (or other testamentary documents) and submit it to the Court for certification and appointment as Executor. An opportunity is provided for others to object to the appointment of the Executor or question validity of the Will.
2. Once appointed, the Executor has legal authority over the estate and its assets and is responsible for locating, preserving, and maintaining property and assets of the estate.
3. The Executor must take an inventory and value all of the assets and property in the estate, and must account for all expenditures and income during administration of the estate.
4. The Executor must attempt to identify all creditors or others who may have a claim against the estate. This usually includes advertising to notify those who believe they may have a claim so that they have an opportunity to come forward and seek payment.
5. Then the Executor pays the valid claims and denies others. At this point a court hearing may be held to allow those who have not been paid to have an opportunity to object.
6. The final income tax return and estate tax return are prepared and filed.
7. In most cases the Executor must provide the court with a final accounting and inventory and seek permission to make distributions according to the Will.
8. Finally, distributions are made.

The entire process can easily take a year or more following the death of the donor. Charities should monitor the process and, while exercising patience, be vigilant to make certain that the process is moving along and to ensure that the donor's charitable wishes are carried out.

Charitable Bequests

The most straightforward way to make a testamentary gift is by a charitable bequest—a provision included in a Will or trust directing a gift to charity upon the death of the donor. There is an almost endless variety of ways in which a charitable bequest can be structured. Some of the most common forms are:

Specific bequest – an exact amount, or a specific item, is left to charity

- "I bequeath the sum of $100,000 to..."

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- "I direct my Executor to distribute my collection of barbed wire to…"

Percentage bequest – a percentage or fraction of the estate is left to charity, often used with a remainder or residue provision

- "I bequeath 50% of my estate to …"
- "I direct my Executor to distribute one-half of the remainder to…"

Bequest of remainder or residue – directs that what is left (if anything) after other distributions should be given to charity, often expressed as a percentage

- "I bequeath all of the rest remainder and residue of my estate to..."
- "I direct my Executor to distribute one-third of the remainder to…"

Contingency bequest – a contribution is to be made only if certain other things happen first (e.g., my spouse dies before I do)

- "If I am trampled to death by a herd of buffalo in the starboard isle of a west-bound Boeing 747, then I bequeath..."

Restrictions

Donors often wish to provide instructions or restrictions as to how their charitable bequest should be used. These restrictions can become problematic if the direction is unclear, or if it is impractical. Ultimately, the charity may be forced to decline the bequest if the restriction is unacceptable.

In order to avoid these complications, charities often suggest that the donor set forth the restrictions in a memorandum or other written document negotiated with the charity. Then, the provision in the Will can direct that the bequest "...be used in accordance with the most recent memorandum that I have placed on file with Charity." Of course, the donor should seek the advice of his or her legal counsel as to what details should be included in the Will.

In addition, it is prudent to ask donors to include "safety valve" language, such as:

> "If the Board of Directors determines that it has become unwise or unnecessary to use this gift for the purposes I have specified, then I direct that this gift be used for other purposes the Board of Directors may designate, bearing in mind my original intention."

QUALIFIED RETIREMENT PLANS

There are a number of retirement plans under current tax law. "IRA," "Keogh," "401(k)," and "403(b)," are just a few of the "qualified retirement plans." Qualified retirement plans are designed to encourage individuals to save money to be used to provide income in their retirement years.

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In general, qualified retirement plans offer the opportunity to set aside pre-tax income and invest that money on an income tax deferred basis. Since no taxes are paid on the money as it is earned, nor as it is invested and grows, withdrawals from qualified retirement plan are subject to income tax.

In addition, since these programs are designed specifically to provide retirement income, they are subject to a number of rules that make it unattractive to use them for other purposes. There is a minimum age (generally 59½) before which withdrawals are subject to a penalty. In addition there are requirements mandating minimum withdrawals each year, generally beginning at age 70½.

In general, qualified retirement plans are *not* a good source of funds for lifetime charitable gifts because the donor will have to recognize as taxable income any amounts withdrawn from the account. Even though the charitable deduction can offset the additional taxable income, the complexities involved—including the likelihood that the administrator will be required to deduct standby withholding— make lifetime gifts from qualified plans unattractive to donors. However, new legislation signed into law late in 2015 rule simplifies certain lifetime contributions of IRA assets for donors age 70½ or older (see "Charitable IRA Rollover" below).

In any case, qualified retirement plan assets make an *excellent* testamentary gift. The reason is very simple:

- Any amount left in a qualified retirement plan at death is treated as though it was withdrawn by the estate. The effect is that the total amount left in a qualified retirement plan at death is subject to income tax. What is worse, the taxable income on an individual's final income tax return is often higher than in prior years resulting in a higher marginal income tax rate and perhaps triggering the Medicare surtax.
- However, transfers from a qualified retirement plan directly to charity at death escape the income tax completely!

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***Example:* Testamentary Contribution of IRA versus Charitable Bequest**

A donor has a modest sized estate worth $500,000 including a home, life insurance policies, other assets and an IRA worth $100,000. The donor has decided to make a charitable bequest of $100,000 to charity and wants the rest of his estate go to heirs. In order to accomplish this, the donor has written a Will that directs $100,000 to charity and the rest of the estate to heirs. Here are the effects of a gift of the IRA to charity versus the simple charitable bequest provision:

	Simple Charitable Bequest	IRA Directed to Charity
Value of estate including IRA	$500,000	$500,000
IRA transferred to charity	n/a	(minus) $100,000
Income tax on IRA (assume 32%)	(minus) $32,000	-0-
Charitable bequest	(minus) $100,000	n/a
Remainder to heirs	$368,000	$400,000

By naming the charity as the remainder beneficiary of the IRA the donor could save $32,000 in income taxes (more if the Medicare surtax is triggered) that will be due on the IRA—money that will reduce the value is passed to the heirs.

CAUTION: The rules surrounding IRAs and other qualified retirement plans are complex. Donors should work with their retirement plan administrators and other advisors in order ensure that this plan works to their benefit.

NOTE: This example illustrates income tax savings only. For larger estates, there are potential estate tax savings, too.

"Charitable IRA Rollover"

A special rule made permanent by Congress in December 2015 allows certain donors to use their IRA assets to make a "qualified charitable distribution" without incurring income tax on the withdrawal from the IRA.

- The donor must be age 70½ or older at the time the gift is made.
- The account must be a traditional Individual Retirement Account (IRA) or Roth IRA.
- The contribution must be outright (no life income plans).
- Total IRA rollover contributions cannot exceed $100,000 for the year.
- The transfer must be from the IRA administrator directly to the charity (the donor cannot withdraw the money and then make a contribution to the charity).
- Contributions must be to a public charity. They cannot be to a donor advised fund, supporting organization, or private foundation.

Note that the donor does not receive an income tax deduction for a qualified charitable distribution.

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The charitable IRA rollover appeals to donors for reasons that include:

- It is relatively simple to complete.
- It does not increase the donor's taxes, even if the donor's charitable deductions are limited in some way or the donor does not itemize deductions.
- It counts toward the donor's required minimum distribution.

GIFTS OF LIFE INSURANCE

Life insurance is a powerful and flexible financial and estate planning tool. For charitable giving purposes, the value for the charity lies in receiving the "death benefit" that is paid upon the death of the insured. However, policy loans, withdrawals, and other obligations can reduce the dollar amount coming to the charity.

Life Insurance Basics

Before we discuss the practical applications of life insurance as a charitable gift, a brief review of the basics of life insurance:

- **Policy** – Life insurance is a legal contract (the "policy") promising to pay a certain amount (the "death benefit") upon the death of an individual (the "insured").
  - The insurance company seeks a large number of people to insure in order to spread the risk of having to pay the death benefit in any one year.
  - The company charges a fee (the "premium") for the policy and uses this money to pay death benefits to the beneficiaries of those insureds who die.
- **Term Life Insurance** – "all life insurance is term insurance"
  - The policy covers one life for a specified period of time (usually one year).
  - The amount of the premium increases each year as the likelihood of paying the death benefit during that year increases because the insured is older.
  - **Annual renewable term** – The insurance company promises to renew the coverage each year—but at a higher premium for the same death benefit.
  - **Decreasing term** – The insurance company promises to renew the coverage each year for the same premium, but with a smaller death benefit.
- **Whole Life Insurance** – The premium stays the same and the coverage stays the same for the life of the insured.
  - In the early years the premium for a whole life is significantly higher than for the same coverage under a term insurance policy.
  - The extra premiums collected in the early years are accumulated and invested to be used to pay the higher cost of insurance in later years when the insured is older.

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  - The insurance company guarantees that a specific value in death benefit will be paid as long as premium payments are made on time regardless of investment performance, mortality experience, or other vagaries during the life of the insured.
- **Universal or Variable Life Insurance** – Both the premium amount and the value of the death benefit may be adjusted during the course of the policy.
  - Similar to whole life policies, excess premiums are accumulated to be invested and used later to pay the cost of insurance.
  - Most of the variables, including the cost of insurance, mortality assumptions, investment return and value of death benefit, are not guaranteed and can be adjusted from time to time.
  - The policy owner may be provided some opportunity to select the investments owned by the policy.
- **Limited Payment or "Vanishing Premium" Plans**
  - A limited number of annual premiums are projected, after which a sufficient policy value is expected to have accumulated in order to pay the cost of insurance for the lifetime of the insured.
- **Single Premium or "Paid Up" Life Insurance**
  - One very large premium is paid at the time of purchase, most of which is set up as an investment account to pay the cost of insurance for the lifetime of the insured.

Life Insurance Vocabulary

Life insurance employs a very specific and technical vocabulary. An understanding of several key terms will be helpful in the evaluation and comparison of charitable life insurance proposals:

Account value	The sum of all premium payments adjusted by periodic charges, credits and partial withdrawals
Annuity	A contract issued by an insurer that promises to pay periodically an amount to a beneficiary (the amount of the annuity can be fixed or variable and continue for the lifetime of the insured or last for a shorter period depending upon the terms of the contract)
Beneficiary	The individual or entity to whom the death benefit or periodic annuity is to be paid
Cash surrender value	The cash value available upon surrender of the insurance contract

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Death benefit	The amount paid upon the death of the insured (the amount of the death benefit can be guaranteed and fixed at the time the policy is issued or it can vary depending upon the terms of the contract, the net amount available may be reduced by loans or withdrawals made before the death of the insured)
Guaranteed value / guaranteed rate	Policy illustrations usually include certain minimum or guaranteed rates of investment return as well as assumed rates of investment return; guaranteed policy values are those projected based upon the guaranteed rates while values based upon the assumed rates are not guaranteed
Insured	The individual upon whose life a policy or annuity is issued
Insurer	The insurance company that issues the policy or annuity
Owner	The individual or entity that owns and controls the policy
Policy	A contract issued by an insurer which promises to pay a death benefit to the beneficiary upon the death of the insured
Policy year	The "fiscal year" of the policy, generally beginning the first day the life insurance coverage is in place; premium payments and other outlays are usually assumed to be made at the beginning of the year while cash values are usually shown as of the end of the policy year
Premium	The amount paid to the insurer in exchange for the contractual promises of the policy (insurance policies usually require periodic payment of premiums during the lifetime of the insured, annuities usually require a single premium payment when the contract is issued)

Outright Contributions of Life Insurance

If a charity is named as the "beneficiary" of the policy, the charity will receive the death benefit amount when the insured dies.

If, instead, the donor assigns "ownership" of the policy to charity (in addition to naming the charity as the beneficiary), the donor receives a current income tax deduction for "interpolated terminal reserve value" (basically the "cash value," subject to certain adjustments) of the policy. In addition, if the donor makes premium payments on the policy after it has been contributed to the charity, he or she can receive an income tax charitable deduction for those amounts too.

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Note: Policy loans, withdrawals, and other obligations may decrease, sometimes significantly, the value of the policy to the charity.

Donors should be advised that the charity, as owner of the policy, has sole discretion to make decisions that will affect the value of the policy to the charity:

Further premium payments – the charity is *not* obligated to make any further premium payments on the policy

Policy loans – the charity can borrow the cash value from the policy

Paid-up insurance – the charity may elect to accept a smaller death benefit and eliminate the need for further premium payments

"Wealth Replacement" Life Insurance

Since planned gifts often remove estate assets that would otherwise have gone to surviving heirs, life insurance naming the heirs as the beneficiary can provide a cost-efficient way to replace the assets given to charity.

Those donors who are concerned about estate taxes can work with their financial advisors to ensure that wealth replacement policies are owned by the heirs. Ownership by the heirs can avoid estate taxes on wealth passed to the next generation.

Evaluating Life Insurance Contributions

It seems there is a never-ending array of programs promoting creative applications for life insurance in charitable giving. Before engaging in any life insurance program, the charity should engage in a careful review of the proposal to ensure that there is real value for the charity.

The National Association of Charitable Gift Planners (formerly the Partnership for Philanthropic Planning) has published guidelines for the evaluation of life insurance. These guidelines are available from the Partnership's Web site https://charitablegiftplanners.org/standards/charitable-life-insurance-evaluation-guidelines. The key elements of the recommended review are:

Complete Analysis – Careful analysis of both the subjective and objective factors is key. Some aspects of charitable life insurance programs lend themselves to quantitative analysis, while other aspects are more qualitative in nature. A worthwhile charitable life insurance program will meet both subjective and objective criteria.

Value and Values – The analysis should guard both the value and the values of the charitable organization today and in the future. Even though a charitable life insurance program may be financially viable, it may still present unwarranted risk to reputation and/or consume unreasonable amounts of valuable staff time and resources.

Nothing is Free – Nothing of value comes without a price. All of the costs of the charitable life insurance program, including the costs of insurance, borrowing, commissions, and on-going administration, must be paid by someone at some point. The charity should have a clear understanding of all of these costs and the sources of the funds

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to pay these expenses, as well as the ultimate source of the value the charitable organization expects to receive.

Charitable Interest – The charitable life insurance program must respect and serve the charitable interests of the donor.

Obligations and Commitments – Charitable organizations should fully understand the obligations involved in a proposed charitable life insurance program and the impact should the program not unfold as planned. Interest rates, mortality assumptions, and the cost of insurance are all variables that may increase or decrease the charity's out-of-pocket expenses over time.

BARGAIN SALE GIFTS

A "bargain sale" occurs when a donor sells property to a charity for less than its full fair market value. For tax purposes, the transaction is viewed as having two elements; a sale and a gift. The donor is allowed an income tax deduction for the difference between the sale price and the fair market value of the property.

Under certain circumstances, a bargain sale can be advantageous to both the donor and the charity. For example, a donor may be willing to "contribute the appreciation" he or she has earned on an asset but determined to retain his or her initial investment in the asset. Although, as we will see below, the capital gains tax rules make it impossible to separate the appreciation from the cost basis, a donor can use a bargain sale to effectively share a specific portion of an asset's value with a charity. In another example, a donor may wish to contribute only some of the value of an asset that cannot be easily divided.

Bargain sale gifts that should be approached with special caution include: appreciated short term property, ordinary income property, mortgaged property, stock redemption plans, and tangible personal property. Although a bargain sale is possible in these situations—and can even be mutually advantageous to both the donor and the charitable institution—the guidance of qualified counsel should be sought before proceeding.

Note: The donor of a bargain sale gift will owe capital gains tax on the portion of the property that was sold. For example, if a donor owns a property now worth $50,000 with a cost basis of $20,000, the donor has a $30,000 gain in the property ($50,000 sale price minus $20,000 basis). Put another way, 60% of the total value of the property is capital gain, which means that 60 cents of each dollar received in a sale would be capital gain and the remaining 40 cents would be recovery of cost basis. The same ratio applies to the portion sold by the bargain sale donor. If the donor sells the property to charity for $10,000, he or she will be liable for capital gains tax on $6,000 of capital gain (60% of $10,000).

The bargain sale can become even more complex if the property is mortgaged or if the donor has taken accelerated appreciation deductions related to the property. Under the appropriate

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circumstances, such gifts can be acceptable: however in some cases the donor will incur taxable income in addition to capital gain. Donors should be urged to consult their own tax advisors before completing a bargain sale.

Finally, the charity should carefully evaluate the implications before accepting a bargain sale gift. Two considerations should be paramount:

- Is the property usable and valuable to the charity in its mission? If not, is it readily marketable so that the charity can use the proceeds for its charitable work? Since the charity will be committing financial resources to the purchase, there should be a reasonable likelihood that the transaction will result in additional support for the mission of the charity.
- Does the charity have sufficient resources to engage in the purchase? The initial cash purchase may be only the beginning. There may be expenses and costs if the property cannot be sold quickly.

FAMILY FOUNDATIONS

The notion of a "family foundation" can be very appealing to generous individuals. A family foundation is a way to have an impact on an array of organizations over an extended period of time and to provide family members and others with opportunities to influence charitable giving now and in the future. Interestingly, there is no legal definition of "family foundation." Most often a private foundation is the vehicle used to establish a "family foundation." Increasingly, however, donors are using a donor advised fund as an alternative way to establish a family foundation.

Private Foundation

A private foundation is a separate tax-exempt entity, created either as a non-profit corporation or in the form of a trust. The private foundation accepts contributions from one or more donors. The governing board of the private foundation manages and administers its assets and makes distributions, or grants, for charitable purposes.

Private foundations are subject to a number of restrictions — the private foundation rules — that prohibit transactions between the private foundation and its founders, donors, or individuals or parties related to them. As a separate legal entity, a private foundation must provide for its own administration, accounting, and investment management. It must also complete and file its own tax and information returns each year, which must be made available to the public on request.

Donor Advised Fund

Donor advised funds are among the fastest growing vehicles for personal philanthropy. Although donor advised funds are most often created through community foundations, other public charities sometimes sponsor donor advised funds. Several financial institutions, including Fidelity Investments, Vanguard, and Charles Schwab, operate very large donor advised funds.

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Through a written agreement with the sponsoring charity, a donor creates a specially named fund account to which contributions are made. The terms of the agreement allow the donor (or others) the privilege of making non-binding recommendations regarding charitable distributions that the sponsoring charity makes from the fund.

Since the donor makes contributions directly to the sponsoring charity, contributions to the fund are charitable contributions to a public charity rather than gifts to a private foundation. Since a charitable contribution must be "complete" in order to qualify for tax deduction purposes, the donor's recommendations as to the use of the contribution must be advisory only and the governing body of the sponsoring charity must have final control over all distributions.

The table below compares several aspects of a donor advised fund and a private foundation.

	Donor Advised Fund	**Private Foundation**
tax-exempt status	gets public charity status from the sponsoring charity	establish separate tax exempt status as private foundation
charitable deduction limit	60% / 30% of AGI	30% / 20% of AGI
donor control over grant making	donor may recommend distributions but charity makes final decision	donor retains significant control subject to IRS private foundation rules
minimum payout requirements	none (except by policy of sponsoring charity)	at least 5% of asset value each year (regardless of income)
start-up	established by agreement with sponsoring charity	non-profit entity must be established and separate tax exempt status secured
practical minimum size	depends upon policy of sponsoring charity, often as little at $10,000	substantial assets required, typically $1.0 million or more
annual taxes	none	subject to excise tax of up to 2% of net investment gain
annual tax filings and returns	none required, reported as a part of the sponsoring charity's annual return	separate tax and information return must be filed annually along with required schedules
administration and investment management	provided by the sponsoring charity	must establish or secure its own services

(Text adapted from the book *Planned Giving in a Nutshell* and used with permission of the author.)

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