FUNDAMENTALS OF PLANNED GIVING

PART ONE: TAX FUNDAMENTALS

PG CALC WEBINAR

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INTRODUCTION

For many of us, the U.S. Federal Tax Code seems like the most complex set of laws and regulations ever written. What is more, Congress is forever adjusting, changing, and tinkering with the tax laws. Fortunately, in order to be successful a charitable gift planner needs to be conversant with only a few key concepts in the Federal tax law. It's true that many gift planners pursue a much broader knowledge and deeper understanding of tax law—and that can be a definite advantage. However, a confident understanding of the basic concepts is sufficient for most gift planners.

The point is this: a gift planner need not become an expert in all of the subtleties and nuances of tax law. The job of the non-profit gift planner in particular is to suggest creative solutions to prospective donors. Donors should always consult their own advisors in order to ensure that a contemplated gift will perform in the way they anticipate. Gift planners, particularly those employed by charitable organizations, should never exceed the limits of their expertise and knowledge.

We begin with the following tax fundamentals because a grasp of the basics of income and estate taxes applied to charitable giving is essential to understanding the charitable giving vehicles and how they can benefit the donor. Our emphasis is on the donor's "after-tax cost of a gift" and the ways in which careful planning can encourage donors to make larger gifts than they thought possible.

THE FEDERAL TAX SYSTEM

There are two Federal tax systems that are of particular interest in charitable gift planning:

- Income tax system – including income taxes and capital gains taxes
- Transfer tax system – including estate taxes and gift taxes

Tax incentives to encourage charitable giving are included in both the income and transfer tax systems. However, the impact of these incentives on an individual donor varies depending upon the donor's personal circumstances. While the income tax system itself generally applies to all taxpayers, the greatest income tax incentives for charitable giving are available only to the approximately one-quarter of taxpayers who itemize their deductions. On the other hand, the transfer tax affects only a very small percentage of all taxpayers—estimates are that the Federal Estate Tax[1] applies to fewer than 1% of estates—but in many cases the value of estate tax incentives is greater than the value of income tax savings.

After-Tax Cost of Giving

[1] Under the American Taxpayer Relief Act of 2012, the Federal Estate Tax applies to estates with a taxable value of $5.45 million or more for those dying in 2016 (the amount is adjusted for inflation each year. According to the Urban-Brookings Tax Policy Center, less than 1% of all estates are subject to the Federal Estate Tax.

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A key concept for charitable gift planners is the "after-tax cost of the gift." The after-tax cost of a gift is, simply, the amount of the gift minus the amount by which the contribution reduces the donor's tax bill:

	Amount Contributed
minus	Amount of Tax Reduction
equals	After-Tax Cost of Gift

The tax savings are real. Even though the donor may not receive the savings until the following April 15 when he or she files a tax return, the tax reduction reduces the donor's cost of making a charitable contribution. And, since most tax rates are progressive—that is the rate rises as the taxable amount increases—the amount of tax savings is relatively greater for donors in higher tax brackets. This means that the after-tax cost of making a gift is lower for higher bracket taxpayers.

THE FEDERAL INCOME TAX

Ordinary Income Tax

The Federal income tax generally applies to all "income" from whatever source. However, not all income is taxed because a number of exclusions and deductions reduce the amount of income that is ultimately taxable. Most taxpayers file some variant of the Form 1040. In general, "taxable income" is calculated as follows:

Gross Income	everything earned or received as income during the year
minus adjustments	certain items (e.g., casualty losses, alimony payments, IRA contributions) are subtracted from gross income
Adjusted Gross Income	"AGI" is a key figure that determines the maximum amount of charitable deduction that can be taken in any one year
minus personal exemptions	a flat amount is subtracted for the taxpayer and each dependent claimed on the return (the exemption amount is $4,050 in 2016 and is adjusted for inflation each year)[2]

[2] The value of the personal exemption is phased out for high income taxpayers. In 2016 individuals with adjusted gross income over $259,400 (or married couples filing jointly with adjusted gross income over $311,300) must reduce the amount of their personal exemptions by 2% for each $2,500 (or portion of $2,500) that their adjusted gross income exceeds the threshold. As a result, in 2016 the personal exemption phases out completely at $384,400 in adjusted gross income for individuals (and $436,300 for married couples filing jointly). These thresholds are adjusted for inflation each year.

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minus deductions	certain items—including charitable contributions—are deducted from income; however, deductions are itemized deductions only if they exceed the "standard deduction" amount ($6,300 for single filers and $12,600 for joint filers in 2016, adjusted each year for inflation)[3]
Taxable Income	the amount subject to Federal Income tax

Key Point → **The charitable deduction reduces taxable income, and therefore reduces the amount of income tax due.**

Federal Income Tax rates are "progressive" so that a higher percentage rate applies to larger amounts of taxable income. They are also "graduated" so that everyone pays the lowest rate on the first dollar of taxable income and only those who have larger amounts of taxable income are subject to the higher rates. The tax "brackets" (dollar ranges at which each rate is effective) are adjusted for inflation each year. Below are the income tax rates for 2016:

Tax Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10%	$0 – $9,275	$0 – $18,550	$0 – $9,275	$0 – $13,250
15%	$9,276 – $37,650	$18,551 – $75,300	$9,276 – $37,650	$13,251 – $50,400
25%	$37,651 – $91,150	$75,301 – $151,900	$37,651 – $75,950	$50,401 – $130,150
28%	$91,151 – $190,150	$151,901 – $231,450	$75,951 – $115,725	$130,151 – $210,800
33%	$191,151 – $413,350	$231,451 – $413,350	$115,726 – $206,675	$210,801 - $413,350
35%	$413,351 – $415,050	$413,351 – $466,950	$206,676 – $233,475	$413,351 -- $441,000
39.6%	$415,051 and over	$466,951 over	$233,476 and over	$441,001 and over

Note: The tax table used depends upon the filing status of the taxpayer (e.g., single, joint, etc.).

One of the implications of the graduated tax rate system is that the "marginal tax rate"—the top tax rate that is applied to the last dollar of taxable income—is usually much higher than the "effective tax rate"—the overall tax rate paid. For example, a taxpayer filing jointly in 2016 with a taxable income of $175,000 will pay a total tax of $32,266, as follows:

Taxable Income	Tax Rate	Tax Due
the first $18,550	10%	$1,855
the next $56,750	15%	$8,513
the next $76,600	25%	$19,150
the last $23,100	28%	$6,468

[3] The value of the itemized deduction is reduced for high income taxpayers. In 2016 individuals with adjusted gross income over $259,400 (or married couples filing jointly with adjusted gross income over $311,200) must reduce the total of their itemized deductions by 3% of the amount that their adjusted gross income exceeds the threshold. However, the reduction cannot be more than 80% of the total itemized deductions (i.e., even the wealthiest taxpayers will retain at least 20% of their itemized deductions). These thresholds are adjusted for inflation each year.

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TOTALS	$175,000	20.5%	$35,986

A total tax of $35,986 on a taxable income of $175,000 is an "effective rate" of about 20% even though the "marginal rate" paid on the last taxable dollar earned is 28%.

Capital Gains Tax

For our purposes, "capital gain income" is the "profit" when an investment is sold for more than it cost. It is "long term capital gain income" if the investment was owned for more than twelve months before being sold and is "short term capital gain income" if held for a year or less. Short term capital gain income is taxed at ordinary income tax rates. However, long term capital gain is taxed at lower rates: a maximum rate of 15% for most taxpayers and 20% for those in the top income tax bracket[4]. For example, if a taxpayer in the 28% bracket sells for $10,000 an investment that cost $2,000 some years ago, he or she will owe a tax of $1,200—15% of the $8,000 long term capital gain.

There are a few exceptions where capital gains may be taxed at rates greater than 15%:

- The taxable part of a gain from selling "section 1202 qualified small business stock" (stock in a qualified small business issued to the taxpayer after August 10, 1993 in exchange for money or other property (not including stock), or as compensation for services) is taxed at a maximum 28% rate.
- Net capital gains from selling collectibles (like coins or art) are taxed at a maximum 28% rate.
- The portion of any unrecaptured section 1250 gain (a type of depreciation-recapture income that is realized on the sale of depreciable real estate) from selling section 1250 real property is taxed at a maximum 25% rate.

After-Tax Cost of a Gift

A charitable contribution is deductible from taxable income, thereby reducing the amount of income tax due. This tax savings effectively reduces the cost of making a contribution.

[4] There is a 0% long term capital gains rate for taxpayers whose taxable income is less than the top of the 15% marginal tax bracket ($75,300 for joint filers in 2016 and $37,650 for singles – the brackets are adjusted for inflation each year). The 20% long term capital gains rate applies to taxpayers in the 39.6% income tax bracket: a taxable income of over $466,950 if married and filing jointly, over $415,050 if single in 2016.

While the general long term capital gains tax concepts outlined here apply to most gift planning circumstances, as always, prospective donors should be encouraged to consult a qualified tax advisor for advice on their specific circumstances and to review the latest revisions to tax law.

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***Example:* After-Tax Cost of a Gift of Cash**

Assume a donor who is in the 28% marginal tax bracket makes a cash contribution of $10,000:

$10,000	:	cash contribution
-2,800	:	income taxes saved
$7,200	:	after-tax cost of the contribution

Key Point → **The charitable deduction reduces taxable income at the margin (the last dollar of income) and therefore produces tax savings at the taxpayer's highest marginal tax rate.**

Amount of the Deduction: Fair Market Value

In general, a donor is entitled to a charitable deduction for the "fair market value" of the contribution. The fair market value is defined as the price that would be reached between a willing buyer and a willing seller, both having equivalent knowledge of the facts and neither being under any compulsion to complete the transaction.

Determining the fair market value is straightforward for most contributions:

cash – total of the cash contributed

publicly traded securities – the mean (average) between the high and low prices for the securities on the date of the contribution

However, the rules become more complicated for items that are harder to value, such as real property, collections, and personal items. In general, the donor must make a reasonable estimate of the fair market value and must obtain a "qualified appraisal" if the deduction is $5,000 or more.

Notes:

Valuation of "non-cash" contributions has been the subject of increasing scrutiny by the Internal Revenue Service and Congress in recent years. The rules have been changed and deductions for non-cash contributions are being scrutinized more carefully. IRS Publication 526, *Charitable Contributions*, and Publication 561, *Determining the Value of Donated Property* are very useful guides. Current versions are available on the IRS Web site: http://irs.gov

Substantiating the value of a charitable deduction is a matter between the donor/taxpayer and the Internal Revenue Service. Although charities should, of course, be helpful to their donors, it is best to leave the matter of valuation of contributions to the donor.

Donors should be fully informed that the amount of their charitable deduction may be significantly different from the amount eventually received by the charity. For example, while the deduction for a contribution of appreciated securities will be based upon the average between the high and low prices on the date of the gift,

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the amount received by the charity will depend upon the actual sales price (minus commissions and other costs of sale).

After-Tax Cost of Gift of Appreciated Property

A donor may contribute long term capital gain property to charity, receive an income tax deduction for the full fair market value of the property, and pay no capital gains tax, which would have been due if the property had been sold.

Example: **After-Tax Cost of a Gift of Appreciated Securities**

Assume a donor who is in the 28% marginal tax bracket contributes securities now worth $10,000 that the donor purchased for $2,000 more than a year ago:

$10,000	:	value of securities contributed
-2,800	:	income taxes saved ($10,000 x 28%)
-1,200	:	capital gains tax avoided ($8,000 x 15%)
$6,000	:	after-tax cost of the contribution

Key Point → **A donor can receive a charitable deduction and avoid capital gains taxes by contributing long term capital gain property to charity.**

Notes: In order to avoid the capital gains tax on a contribution of appreciated property, it is extremely important that the donor contribute the appreciated property itself, not the proceeds from the sale of the appreciated property. In short, if the sale of the property is arranged before the contribution, then the donor may be deemed to have sold the property and contributed the proceeds from the sale, in which case the donor would be liable for capital gains tax on the sale.

Securities are the most common contribution of appreciated property. In the case of a contribution of securities, it is critical that stockbrokers understand that they are to transfer the securities themselves to the charity, and that they should not sell the securities except at the direction of the charity as owner.

In other cases, for example real estate, it is critically important that there be no pre-arranged agreement to sell or buy the property prior to the contribution to charity.

Deduction Limitations

Although charitable contributions are 100% deductible, the maximum amount a donor can claim in any one year is limited to 50% of Adjusted Gross Income (AGI) for contributions of cash and 30%

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for contributions of appreciated property.[5] Charitable deductions that exceed the limit in one year may be carried forward for up to five additional years.

For example, assume a generous donor has Adjusted Gross Income of $160,000 and makes cash contributions totaling $100,000 during the year. Her or his charitable deduction for the year would be limited to $80,000 (50% of Adjusted Gross Income) leaving $20,000 in unused deduction that the donor can use to reduce taxable income in the following year. (Note that taxpayers are required to use as much of their charitable deductions as they can each year. They cannot save or time the use of their charitable deductions.)

There are special rules that govern the interplay between the 50% limit and 30% limit when a donor has contributed both cash and appreciated property. If your contributions consist of both cash (50% limit) and appreciated property (30% limit) you must first deduct all contributions subject to the 50% limit, up to 50% of adjusted gross income. Then you may deduct contributions subject to the 30% limit up to the lesser of 30% of adjusted gross income, or 50% of adjusted gross income minus your 50% contributions. In any case, unused deductions may be carried forward for up to five additional years.

For example, assume your adjusted gross income is $50,000 and in March, you gave your church $2,000 cash and made a contribution of long term appreciated property with a fair market value of $28,000. The $2,000 cash donated to the church is considered first and is fully deductible because it is less than 50% of your adjusted gross income. You are also allowed to deduct $15,000 (30% × $50,000) this year for the contribution of appreciated property. In total, your deduction for this year will be $17,000, however the unused portion of the appreciated property contribution ($13,000) can be carried over for deduction next year and four additional years, if necessary.

In addition, a donor may elect to have 30% contributions (gifts of appreciated property) treated as 50% contributions. However, the deduction will be limited to the cost basis of the appreciated property and the election will apply to all appreciated property contributions. Although, under certain circumstances, this election may be advantageous, this is a complex matter and the donor should be urged to consult his or her tax advisor.

The charitable deduction rules are detailed in IRS Publication 526, *Charitable Contributions*, which is available on the IRS Web site: http://www.irs.gov/pub/irs-pdf/p526.pdf.

Quid Pro Quo Reduction

The amount of the deduction must be reduced by the value of goods or services the charity makes available to the donor as a result of the contribution. This issue arises most often when the charity offers a premium or other reward in exchange for the contribution or in cases of benefit-type events. A key point is that the deduction is reduced by the *value* of the goods or services, not the cost of these items to the charity. In addition, note that it is the *availability* of goods or services that reduces the deduction, whether or not the donor actually receives or takes advantage of them.

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[5] The 50%/30% AGI limits generally apply to contributions to "public charities." Contributions to other charities (e.g., private foundations), while still deductible for income tax purposes, are subject to lower AGI limitations: 30% for contributions of cash and 20% for contributions of appreciated property.

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This information should be completely disclosed to the donor at the time of the contribution. Phrases such as "deductible to the extent allowed" should be avoided. If the solicitation indicates that a contribution is tax deductible, then it should also provide the details of how much will be deductible.

Finally, where nothing of value has been made available to the donor, the contribution receipt should include a statement that no goods or services were made available as a result of the contribution.

Date of Gift

The charitable deduction becomes available on the date the gift is completed. The date of gift is a key concern for contributions made toward year end because in order to be claimed as a contribution deduction a gift must be completed by December 31 of the year in which the donor wishes to claim the deduction. The general rule is that the date of gift is the day on which the donor has irrevocably and unconditionally surrendered control of the gift. Determination of the date of gift is straightforward for most contributions:

Mode of Contribution	Date of Gift
by mail	postmark date (see note)
physical delivery	date delivered
credit card	date authorized by donor (see note)
electronic/telephone transfer	date completed by bank
stock/security certificates	date delivered in negotiable form
stock/security in brokerage account	date transferred to charity's account

The rules applicable to other situations and circumstances can be found in IRS Publication 526, *Charitable Contributions*, which is available on the IRS Web site: http://www.irs.gov/pub/irs-pdf/p526.pdf

Notes: Donors can create unanticipated complexity if they procrastinate at year end. For example, while a contribution dropped in the mailbox at the post office minutes before midnight on December 31 is no longer under control of the donor and ought to be considered complete, the proof of date will be the postmark which is likely to be January 2 of the next tax year. Similarly, credit card contributions are often processed in batches (either by the charitable organization or an intermediary) with the result that the transaction will appear on the donor's credit card statement at a later date than the donor intended. The best advice as year-end approaches? "Don't delay, give today."

As a general rule, the donor must surrender control over the gift in order for the contribution to be complete. While in most cases this is not an issue, gift planners should be careful to avoid inadvertently creating circumstances under which a gift is not complete because of commitments made to the donor. For example, if a contribution is made subject to a promise that unused funds will be returned to the

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donor, then the gift will not be completed until that contingency is removed.

Substantiation Requirements

As noted above, it is the donor's responsibility to substantiate the fact and amount of their charitable deduction. Nevertheless, charities usually make efforts to be of assistance to their donors. In general:

- Taxpayers must obtain a written acknowledgement from the charity for any deductible contribution of $250 or more, although the donor need not submit this acknowledgement with his or her tax return.
- If a donor claims more than $500 in deductions for non-cash contributions, he or she must complete Form 8283 (available on the IRS Web site at http://irs.gov) which provides a description of the item(s) contributed and explains how the fair market value was determined. While the donor must have a reasonable basis for the claimed fair market value, an appraisal is not required (except for contributions of clothing and household goods valued at more than $500).
- If the deduction amount is more than $5,000 ($500 for contributions of clothing and household goods), then the donor must also secure a qualified appraisal to determine the fair market value. In addition, the charity must also sign the Form 8283. (Note that by signing the Form 8283 the charity is *not* vouching for the value of the item(s), only acknowledging that it has received the contribution.)
- Contributions of vehicles are subject to special rules. A donor who claims a deduction of more than $500 for a contribution of a qualified vehicle must attach to his or her tax return a copy of a written acknowledgement. The deduction is limited to the lesser of the fair market value of the vehicle or the gross proceeds from the sale of the vehicle unless the charity makes use of the vehicle for its charitable purposes.

Notes: If the charity signs a Form 8283, then it is required to file a Form 8282 if it sells or disposes of the contributed property within three years of the contribution. The Form 8282 requires the charity to report the amount that it received from the sale.

In general, the charity should avoid listing a dollar value on the receipt or acknowledgement for a non-cash gift. A statement describing the property in sufficient detail to identify it is usually enough.

Gifts of Personal Property

The term "tangible personal property" includes all of the "things" that a donor might wish to contribute, for example: equipment, tools, furniture, antiques, coin collections, appliances, or motor vehicles. In general, a donor is entitled to an income tax deduction for a contribution of tangible personal property, but subject to certain rules regarding the use of the item:

"related use" items – If the item can be put to a use that is related to the tax-exempt purpose of the charitable organization, then the donor may take a deduction for the full fair market

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value of the item. For example, a contribution of specialized tools might be a related use contribution if given to a vocational school, but might not be if contributed to a hospice.

"unrelated use" items – If the use of the item is unrelated to the tax exempt purpose of the charitable organization, then the deduction is limited to the *lesser of* the donor's cost basis in the item or its current fair market value.

Note: There is an exception which applies to taxpayers who are "dealers" in certain items of personal property. Contributions of personal property made by a dealer may be a gift of ordinary income property (see below) which generally limits the charitable deduction to cost basis. Donors should be urged to consult their tax advisors regarding the rules that apply in these circumstances.

Gifts of Ordinary Income Property

"Ordinary income property" is any item which, if the donor were to sell it, would result in taxable income. The determination of ordinary income property can be very specific to the individual. For example, a casual collector of dolls is different from one who is a dealer in the same items. For the dealer the dolls are ordinary income property, for the collector they are not.

The income tax deduction for a contribution of ordinary income property is its fair market value less any appreciation in value. Generally, this limits the charitable deduction to cost basis.

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> ***Example:* Contribution of ordinary income property**
>
> Assume an artist contributes a painting he has created to an art museum and that the fair market value of the painting on the day he donated it is $1.0 million. Further assume that the donor spent $100 to produce the painting (the cost of paint, brushes, and canvas), and therefore the appreciation in value is $999,900.
>
> The donor's deduction is limited to $100.

Deductibility of Short-Term Capital Gain Property

Similar to contributions of ordinary income property, the amount deductible for a gift of short-term capital gain property is its fair market value less the amount that would be taxable as short-term capital gain if the property had been sold, which will generally be the cost basis.

Contributions of Capital Loss Property

Of course investments do not always increase in value. Sometimes donors hold capital loss or "depreciated" property—investments that are now worth less than the donor paid for them. Contributions of capital loss property are usually unwise. The charitable deduction for a contribution of capital loss property will be for the current fair market value of the property, which is less than he or she paid for it. Donors with depreciated or capital loss property should consult with their advisors about the advisability of selling capital loss property, giving the proceeds to charity, and using the loss to offset other capital gains. They will forfeit the possibility of using this loss offset if they give the capital loss property to charity instead.

Alternative Minimum Tax

The alternative minimum tax, or "AMT," is designed to ensure that everyone pays at least some income tax. It was enacted out of a concern that some taxpayers might be able to accumulate large deductions and credits and avoid paying their fair share of income taxes. The AMT is a separate calculation that is similar to the regular income tax but that disallows certain deductions and exemptions (e.g., certain depreciation deductions, some mortgage interest expenses, excess long-term capital gains). Although the AMT rates – 26% and 28% - are lower than the highest ordinary income tax rates, the amount of taxable income subject to the AMT is usually greater than the amount subject to ordinary income tax.

Taxpayers affected by the AMT must first calculate their ordinary income tax and then complete the AMT return. They then must pay the *higher* of the two taxes.

The AMT was designed to apply primarily to high bracket taxpayers who were able to take advantage of certain tax breaks in order to reduce or eliminate income taxes. Over the years the AMT applied to more and more middle income taxpayers because many of the thresholds in the AMT were not adjusted for inflation. From 2013 onward, however, the AMT thresholds will be adjusted for inflation each year, which should reduce the number of middle income taxpayers who have to pay the AMT.

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FEDERAL TRANSFER TAXES

A complete discussion of transfer taxes (estate, gift and generation-skipping taxes) is well beyond the scope of this text. For the past two decades Federal transfer taxes have been the subject of on-going debate. They have been temporarily modified from time to time and, for one year, the Federal Estate Tax was eliminated entirely. In 2013 the American Taxpayer Relief Act brought more or less permanent rates and rules to the transfer tax system. Nevertheless, the Federal Estate Tax affects less than 1% of Americans. For these reasons, the following discussion is limited to providing a familiarity with the key points regarding transfer taxes and to highlighting those areas where caution should be exercised when making statements to donors about these taxes.

The estate tax, gift tax, and generation skipping transfer tax are taxes on the transfer of money, property, or other items of value *from one individual to another*. Essentially, any transfer of value from one person to another is potentially subject to a Federal transfer tax. However, most people are not affected by these taxes because of generous exclusions and exemptions that effectively eliminate these taxes under most ordinary circumstances:

Annual exclusion – An individual can give $14,000 per year ($28,000 for a married couple) to any number of people without a gift tax. In addition, payments of medical expenses on behalf of an individual are excluded from the gift tax. The $14,000 annual exclusion amount is adjusted periodically (but not necessarily annually) for inflation.

Lifetime exclusion – In addition to the annual exclusion amount, an individual can transfer a cumulative total of $5.45 million either as gifts during lifetime or at death without either gift or estate taxes. The $5.45 million exclusion amount is for 2016 and is adjusted for inflation each year.

Spousal exclusion – An unlimited amount can be contributed to a spouse without a gift tax.

Deceased spousal unused exclusion – A surviving spouse can elect to apply the unused lifetime exclusion of a deceased spouse to his or her own taxable gifts during life or at death. So, a married couple can transfer up to $10.9 million in 2016 without gift or estate taxes.

Charitable deduction – There is an unlimited deduction for charitable contributions.

Unified Gift and Estate Tax Rate

Beginning in 2013, all taxable transfers are taxed at 40%. The flat 40% rate replaces the old "Unified Gift and Estate Tax Rate Schedule" which was a progressive rate system beginning at 18% and ranging as high as 55%.

Gift and Estate Tax Summary

Up to $14,000 per year	-	Can be given to each of an unlimited number of individuals (a married couple can give $28,000 per individual)
More than $14,000 per year	-	File a Federal Gift Tax Return and pay 40% tax when cumulative lifetime gifts exceed $5,450,000

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Up to $5,450,000 in total lifetime and estate giving	-	No Federal Gift or Estate Tax
More than $5,450,000	-	Total value of combined taxable lifetime and estate giving in excess of this amount is taxed at 40%
Note that the $5,450,000 exclusion is the threshold for 2016 and is adjusted for inflation each year. The $14,000 annual exclusion is the threshold for 2016 and is adjusted for inflation from time to time (but not necessarily annually).		

Stepped-up Basis versus Carry-over Basis

There is an important difference in the way capital gains are treated under the gift tax and the estate tax. When a taxpayer sells appreciated property that was received as a gift from a living individual, he or she will pay capital gains tax based upon the appreciation in value from the donor's cost basis. However, if a taxpayer sells appreciated property that was received from an estate, capital gains tax will be due only on the appreciation since the date of death.

For example, if, during their lifetimes, parents give their children appreciated property, then the children will be liable for capital gains tax on all of the appreciation that occurred during the parents' ownership as well as after the date of the gift. If the parents instead leave that same property to their children in their Will, then the children will be liable only for the appreciation occurring since the date of death.

Generation-Skipping Transfer (GST) Tax

The Generation-Skipping Transfer Tax ("GST") is designed to prevent wealthy individuals from avoiding one or more levels of taxation by leaving substantial amounts of money or property to grandchildren instead of children, thus skipping the tax that would have been due if they had left it to their children who then left it to their own children. The GST rate equals the highest federal estate tax rate in force at the time of the transfer. Hence, it is currently 40%.

In general, the GST taxes generation skipping transfers as though the transfer had first gone to the intervening generation. For example, if a grandparent transfers to a grandchild, the GST would tax would essentially double the tax as though the transfer had been made from grandparent to parent to grandchild.

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STATE TAXES

Our discussion here has focused on Federal taxes. Each of the States has its own tax laws that can have a significant impact on the after-tax cost of giving. A complete discussion of the States' tax laws is beyond the scope of this summary. However, a few general notes may be helpful.

Some States have income taxes and their own rules about the deductibility of charitable contributions. For residents of these States the after-tax cost of giving can be reduced even further due to State income tax savings. In some States the charitable deduction is limited and in other States there is no State income tax at all. Donors in these States enjoy less or sometimes no additional tax savings as a result of their charitable giving.

Many States have an estate tax. Often, State estate tax law has not kept pace with the changes in the Federal law over the past few years. As a result, the thresholds for State estate taxes can be significantly lower than for Federal estate tax. The consequence is that an estate may be subject to a State estate tax even though it is well below the threshold for Federal taxation. In addition, although State estate tax rates vary, they can be significant, sometimes 15% or more.

State taxes, both income and estate, are deductible from Federal taxes.

SPLIT-INTEREST CHARITABLE GIFTS

Certain charitable gift plans allow the donor or others to retain a financial interest while making an irrevocable charitable gift. For example, charitable gift annuities allow the donor or others to receive payments for life and charitable remainder trusts allow the donor or others to retain income. Another type of gift, the retained life estate, allows the donor to continue to live in a residence after it has been contributed to charity.

Such gifts are called "split interest gifts" because the donor has, essentially, split the ownership interests in the item and contributed the right to hold and own it from the right to either collect payments or, in the case of a retained life estate, live in it. The donor is entitled to a charitable deduction for a split interest gift, but the amount of the deduction is only for the value of the portion contributed, not for the entire value of the item.

The value of the deduction is calculated using formulae, life expectancies, and interest assumptions set forth in U.S. Treasury Regulations. In general, the calculations take into account the amount of time before the charity will receive full ownership of the gift (usually one or more life expectancies) and the amount of the payment (or income) retained and then apply a discount to arrive at the value of the gift to charity.

As a rule of thumb for life income gifts:

- the older the beneficiary (and the smaller the number of beneficiaries) the larger the deduction will be since the charity is likely to receive full use of the gift sooner

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- similarly, the younger the beneficiary (and the greater the number of beneficiaries) the smaller the deduction will be since the charity is likely to have to wait longer to receive full use of the gift
- the larger the amount of the beneficiary payout the smaller the deduction because the value retained by the donor is larger
- and the smaller the payout the larger the deduction because the value retained by the donor is smaller

Charitable Mid-term Federal Rate

One of the key variables in the calculation of the deduction for a split interest gift is the interest (or discount) rate used to arrive at the value of the charitable contribution. Regulations call this the "Charitable Midterm Federal Rate" (or "CMFR"), which is defined as 120% of the "Applicable Federal Midterm Rate" (or "AFR") for the month in which the gift is made, *or for one of the two months prior to the month of the gift*.

The CMFR changes each month. The IRS announces the new rate each month on or about the 20th of the previous month. Typically, the rate is published the next business day in the Wall Street Journal and other financial journals. It can also be found on PG Calc's website: www.pgcalc.com/support/irs-discount-rate.htm.

The CMFR has an impact on the amount of the charitable deduction. Since the regulations allow any one of three different rates (*the month of the gift or either of the previous two months*) to be used, donors should select the rate that produces the most advantageous result for their circumstances. (In fact, with a little careful planning a donor can actually choose from among four rates by waiting until the next month's CMFR is announced before deciding in which month to make the gift.) Usually a donor will choose the rate that yields the largest deduction. Gift annuity donors, however, should consider the impact of the CMFR on the tax-free portion of their annuity payment.

The following general rules can help a donor select the best CMFR:

- the highest of the three allowable CMFRs will produce the best deduction for:
  - charitable gift annuities, but also the lowest tax-free portion of their annuity payments
  - charitable remainder trusts
- the lowest of the three allowable CMFRs will produce the best deduction for:
  - charitable lead trusts
  - retained life estate agreements
- a change in the CMFR will have a much greater impact on the charitable deduction for annuity type arrangements and retained life estate agreements than it will on unitrust arrangements.

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Calculating the Deduction

The amount of the charitable deduction for a split interest gift can be calculated manually using tables and forms available from the IRS. However, PG Calc's *Planned Giving Manager* software quickly and accurately performs these calculations.

Substantiating the Deduction

The donor is required to include the following information with the tax return on which a charitable deduction is claimed for a split interest gift:

- A description of the contribution, including a copy of the instrument (e.g., trust agreement, gift annuity contract) of transfer
- The valuation date of the transfer
- The names, birthdates, and Social Security numbers of the beneficiaries
- A summary of the calculation of the deduction amount showing the CMFR used to value the transferred interest and, if applicable, an explanation that a rate from a previous month has been elected

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

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