TAXATION BASICS FOR GIFT PLANNERS

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I. Introduction

The desire to support the work of one or more deserving organizations is the central motivation for entering into a planned gift arrangement.

However, charitable gift planning is driven in no small measure by the tax incentives that can be associated with making a planned gift. Very often, the size of planned gifts that are made exceed the amounts of other gifts precisely because of the leverage of saving taxes. Nevertheless, it is important to remember that ultimately the donor is parting with an asset in order to benefit charity. You can never get rich by giving money away.

Every fundraiser with responsibility for planned gifts should establish at least a basic understanding of the role played not only by the income tax, but also by the gift, estate, and even generation-skipping transfer taxes. Note: These are all forms of federal taxation, and while many states also have one or more of these taxes, the emphasis in these materials will be on federal taxes.

II. Income Tax Basics

The 2017 Tax Act included many changes to the federal income tax system applicable to individuals. The changes went it effect on January 1, 2018. Most of them will expire on December 31, 2025 unless they are extended by in future legislation passed by Congress. If they are allowed to expire, the federal income tax rules under the preceding law would go back into effect.

Determining Taxable Income

Income tax is computed based on a taxpayer's taxable income. Many details enter into determining a person's taxable income, but they boil down to a few basic steps.

1. Add up your income from all sources, such as wages, interest, dividends, bonuses, and so on. This is your gross income.
2. Subtract above-the-line deductions, such as traditional IRA contributions and health savings account contributions, from your gross income. This is your adjusted gross income (AGI).
3. Subtract below-the-line deductions, such as mortgage interest, charitable contributions, and state and local taxes (all three are subject to certain limitations). This is your taxable income.
4. Compute your tax based on your taxable income.
5. If you have any tax credits, such as for payment of estimated taxes or foreign taxes, you subtract these from your tax to determine the tax owed.

Certain kinds of income, such as qualified dividends and capital gain on a sale of property held more than one year, are not taxed at the standard rates for ordinary income. In determining your total tax, you must determine the amount of each kind of income and the tax associated with that income.

Marginal Tax Rate vs. Effective Tax Rate

The federal income tax system is progressive: the greater the income, the higher the tax due as a percentage of income. In other words, not every dollar is taxed at the same rate. The marginal tax rate is the tax rate that applies to the last dollar of income earned by a taxpayer.

Below is the federal income tax table for 2018 for a married couple filing a joint return. It applies to ordinary income, which includes wages, bank interest, and bond interest.

Taxable Income	Tax	% on Excess
$0	$0	10
19,050	1,905	12
77,400	8,907	22
165,000	28,179	24
315,000	64,179	32
400,000	91,379	35
600,000	161,379	37

The first $19,050 of income is taxed at a rate of 10 percent. For income earned in excess of $19,050 up to $77,400 the tax rate is 12 percent, and so on up to the top bracket of 37 percent. If someone is indeed in the 37 percent tax bracket, it means that every taxable dollar over $600,000 is taxed at a rate of 37 percent, with all dollars below $600,000 taxed at rates ranging from 10 to 35 percent. The highest rate at which a taxpayer's income is taxed is called the *marginal* tax rate. The top marginal rate in 2018 is 37%, which is a reduction from the 39.6% top marginal rate that was in effect from 2013 through 2017. The tax brackets are indexed for inflation, so the taxable income at which each tax rate starts will likely increase a little bit each year.

Some types of income, such as the interest paid on many municipal bonds, are exempt from federal tax. Other types of income, such as qualified dividends and most long term capital gain income, are taxed at capital gains tax rates, which at 15% or 20% are generally lower than ordinary income tax rates. Capital gains tax is discussed in more detail later in this paper.

The *effective* tax rate is the amount of tax a taxpayer pays divided by the taxpayer's total income before adjusting for any deductions, exemptions, or credits. It takes into account the benefit of these adjustments and the progressive nature of the federal income tax.

Taxable Income is the amount of income that is taxed. It equals *gross income* minus "above-the-line" deductions such as retirement plan contributions, other deductions, and exemptions.

Example: *Ted and Alice, a married couple with two children, have a combined gross income of $275,000 and above-the-line deductions of $25,000, giving them an adjusted gross income (AGI) of $250,000. They also have itemized deductions of $40,000. That leaves them with $210,000 of taxable income: $275,000 – $25,000 - $40,000 = $210,000. This places them in the 24% marginal income tax bracket.*

The tax on their $210,000 of taxable income is $38,979, per the tax table above ($28,179 + 24% x ($210,000 - $165,000)). This means their effective tax rate is only 14.2%: $38,979/$275,000 = 0.142.

In the case of Ted and Alice, their effective tax rate (14.2%) is about three-fifths of their marginal tax rate (24%).

Standard Deduction

In the example above, Ted and Alice itemized deductions of $40,000. An itemized deduction is a deduction that the taxpayer lists on Schedule A of their federal tax return. Typical itemized deductions include mortgage interest, state and local taxes, and charitable contributions. A taxpayer's taxable income is reduced by the total of her itemized deductions.

Alternatively, a taxpayer can take a standard deduction rather than itemize. In this case, rather than listing specific deductions on Schedule A and reducing her taxable income by the total of these deductions, the taxpayer simply declares her standard deduction and reduces her taxable income by that standard amount. The amount of a taxpayer's standard deduction depends on her filing status. If a taxpayer's standard deduction is greater than the total of all the deductions the taxpayer would be able to itemize, then the taxpayer will owe less tax by taking her standard deduction than by itemizing her deductions.

The standard deduction nearly doubled under the 2017 Tax Act from $12,700 to $24,000 for a married couple filing jointly and from $6,350 to $12,000 for a single filer. Due to this change and other changes in the Act - primarily the new $10,000 limit on the deductibility of state and local taxes (SALT) and the elimination of most deductions other than for mortgage interest and charitable contributions - the U.S. Congress Joint Committee on Taxation estimates that the fraction of taxpayers who itemize their deductions will drop from 30% in 2017 to 12% in 2018.

Impact of 2017 Tax Act Changes on Value of Charitable Deduction

A charitable deduction will reduce a donor's income taxes only if the donor itemizes her deductions. If she takes the standard deduction, her taxable income will be the same regardless of how much she gave to charity during the year. If the Joint Committee on Taxation's estimate is correct, then, only 12% of taxpayers will derive any tax benefit from their charitable contributions because only 12% of them will itemize their deductions.

Single filers in states with an income tax are more likely to itemize their deductions than other filers. Their standard deduction is only $2,000 greater than the $10,000 limit on the deduction for state and local taxes. If the single filer also pays mortgage interest, she could easily be able to itemize deductions in excess of her standard deduction even without any charitable deductions. For a donor in this situation, every dollar of charitable deduction will reduce her income tax.

Single filers in states without an income tax, in contrast, may need to accumulate several thousand dollars in charitable deductions before their itemized deductions will exceed their standard deduction. The same holds true for married couples filing jointly, since there is a $14,000 gap between the $10,000 limit on SALT deductions and their $24,000 standard deduction.

This gap is actually higher for many planned gift donors: the standard deduction increases by $1,300 for filers who are 65 or older and either married filing jointly or a surviving spouse. For example, if both spouses in a married couple who file jointly are over 65, their standard deduction is $24,000 + (2 x $1,300) = $26,600. The adjustment increases to $1,600 for filers who are 65 or older, unmarried, and not a surviving spouse. The same adjustments to the standard deduction are also made for taxpayers who are legally blind.

For married couples who file jointly and for all taxpayers who pay little in state and local taxes, itemizing deductions is likely to make sense only when they have substantial charitable deductions. Because of their greater size, planned gifts typically produce much larger deductions than annual gifts and therefore may fit well for donors who would like to save taxes with their charitable deductions.

Example: *Alan and June give $10,000 in annual gifts and take $10,000 in SALT deductions. They will take their $26,600 standard deduction rather than itemize their $20,000 in deductions. Consequently, they will get no tax benefit from their philanthropy. However, if they also fund a $50,000 gift annuity that produces a $25,000 charitable deduction, they will be able to itemize $45,000 in deductions, which will reduce their taxable income by $18,400 more than their standard deduction would. If they are in the 24% income tax bracket, they will save 0.24 x $18,400 = $4,416 in taxes by funding the gift annuity.*

Other ways that donors can increase their charitable deductions enough to make itemizing them useful involve consolidating multiple years of typical giving into a single year. A donor can accomplish this by making two or more years' worth of outright gifts in one year, giving little or no money to charity for the next year or more, then repeating the pattern. Another way is for the donor to make a similarly large gift to a donor advised fund (DAF) in one year and then recommend charitable contributions over the next several years that drain the DAF, then repeat the cycle. Some donors may prefer the DAF approach because it allows them to recommend regular annual donations to their favorite charities even though for tax purposes they are making one large gift to the DAF every few years.

Capital Gains Tax

Capital gain is income derived from the sale of an investment asset. A capital asset can be stocks, bonds, mutual fund shares, a home or farm, a business, or a work of art. The capital gain is the difference between what the asset is worth and the owner's cost basis in the asset. The owner's cost basis typically is what the owner paid to acquire the asset, possibly adjusted upwards for certain amounts paid to preserve or enhance its value or downwards for any depreciation claimed by the owner.

There is an income tax on capital gains, just as there is on the different sorts of "ordinary" taxable income, such as wages and interest. The tax rate is lower on "long-term" capital gains, which are gains on assets held for over one year before being sold, than on "short-term" capital gains associated with assets held for a year or less.

The top federal tax rate on most long-term capital gain income and qualified dividends is 15% for most taxpayers and 20% for high income taxpayers. The taxable income threshold for the 20% rate depends on the taxpayer's filing status. As shown in the table below, for example, the threshold for single taxpayers is taxable income over $425,800 and for married filing jointly and surviving spouses is taxable income over $479,000.

Married Filing Jointly Taxable Income	Single Taxable Income	Capital Gains Tax Rate
$ 0	$ 0	0%
77,200	38,600	15%
479,000	425,800	20%

The 15% and 20% thresholds used to coincide exactly with thresholds for income tax rates. For example, the threshold for the 20% federal capital gain tax rate matched the threshold for the top federal income tax rate under each filing status. The 2017 Tax Act has decoupled these thresholds. The 15% federal capital gain tax threshold now almost matches the threshold for the 22% federal income tax rate and the 20% federal capital gain tax threshold occurs in the middle of the 35% federal income tax bracket.

Long term capital gain from the sale of collectibles, such as artwork, antiques, or a stamp collection, is taxed at 28%. Long term capital gain from unrecaptured depreciation is taxed at 25%. These rates apply regardless of the taxpayer's taxable income or filing status.

Both taxes are progressive. For example, if a single taxpayer has taxable income of $360,000 plus another $100,000 of long term capital gain income, the first $65,800 of capital gain income will be taxed at 15% because it is below the $425,800 threshold. The remaining $34,200 will be taxed at 20% because it is above the $425,800 threshold.

Qualified dividends: Qualified dividends are dividends paid by stock in a U.S. corporation or by stock in a foreign corporation that is readily traded on an established U.S. stock market. They are taxed at the same rates as long-term capital gain.

Example: *Mr. and Mrs. Albertson purchased 2,000 shares of Proctor and Gamble stock in September 1994 for $50 a share. There was a two-for-one stock split in March 2000, so the Albertsons now own 4,000 shares. In May 2018, Proctor and Gamble was trading for $75 a share and its annual dividend yield was 4.0%, generating $12,000 in income for the Albertsons.*

If Mr. and Mrs. Albertson sell their Proctor and Gamble stock to reinvest in a higher yielding asset, they would realize capital gain income of $200,000, which is equal to the difference between what they paid for their stock ($100,000) and its current value ($300,000.) Assuming a capital gains tax rate of 15%, the capital gain tax bill on the sale of this stock would be $30,000, which would leave the Albertsons with $270,000 to reinvest.

<u>Impact of Charitable Giving on Taxation of Capital Gains</u>

Capital gain attributable to assets donated outright to charity is completely forgiven. Therefore, if the Albertsons in the example above donated their entire interest in their Proctor and Gamble stock to charity, they would avoid being taxed on any of the capital gain associated with the stock. For many donors, this treatment makes a gift of cash less attractive than a gift of long-term capital gain assets (assets held more than one year) having the same value, as in either case, the deduction will be the same.

If, however, a donor is contemplating donating capital assets held at a loss, she is generally better off selling those assets and then contributing some or all of the resulting cash. This approach allows the donor to recognize a capital loss that may, at least to some extent, reduce the amount of her income subject to taxation. If the donor gives the capital loss property to charity, on the other hand, she will lose the opportunity to recognize the capital loss.

Example: *Mr. and Mrs. Albertson want to make a major gift of $300,000 to your organization's capital campaign. They could fund their gift using the 4,000 shares of Proctor and Gamble stock mentioned in the previous example or using cash. As demonstrated below, they will save more taxes by using their appreciated Proctor and Gamble stock.*

	Give P&G Stock	***Give Cash***
Value of property	*$300,000*	*$300,000*
Cost basis	*- $100,000*	*n/a*
Capital gain	*$200,000*	*$0*
CG tax savings (@15%)	***$30,000***	***$0***
Income tax deduction	*$300,000*	*$300,000*
Income tax savings (@ 24%)	*$72,000 **	*$72,000 **
Total tax savings	***$102,000***	***$72,000***
(CG tax savings + income tax savings)		
Net cost of gift	***$198,000***	***$228,000***
($300,000 – CG tax savings - income tax savings)		

** assumes Albertsons can itemize entire $300,000 income tax deduction*

The Albertsons will avoid $30,000 more in taxes by giving their Proctor & Gamble stock than by giving cash. Even if they don't itemize or can't use all of their $300,000 income *tax deduction, they will still save $30,000 more in taxes by giving the stock and avoiding the capital gains tax that would be due if they were to sell the stock.*

If the Albertsons like owning the Proctor & Gamble stock, they can give their current shares and then use the $300,000 in cash they didn't give away to repurchase 4,000 shares at $75/share. This transaction will increase their cost basis from $25/share to $75/share and thereby reduce substantially the capital gain tax on any future sale of this stock.

Appreciated assets used to fund life income gifts are likewise entitled to favorable capital gains tax treatment. A gift annuity funded with appreciated property will always eliminate the capital gain associated with the gift portion of the transaction. If the donor is also the annuitant, the gain associated with the retained annuity interest can be reported over the annuitant's life expectancy. If the donor is not the annuitant, the donor must report the capital gain associated with the retained income interest in the year of the gift.

The income paid from a charitable remainder trust is generally taxed on a "worst-in, first-out" basis. This means that, with a few exceptions, the most heavily tax-burdened assets are considered the first assets distributed to the income beneficiary. The tax character of the assets in the trust determines how the payments made to income beneficiaries will be taxed. Therefore, if the trust realizes long-term capital gain from the sale of its assets, a portion of the income paid to the beneficiary will be taxed at capital gain rates after any ordinary income earned by the trust has been distributed. Note that a special kind of ordinary income, i.e., "qualified dividends" paid in connection with most publicly-traded securities, is distributed before any capital gain income even though it may be taxed at a lower rate than some of the capital gain income.

Finally, if a short-term capital gain asset is used to make a charitable gift, the capital gain will still escape taxation, but the income tax charitable deduction will be based on the donor's cost basis in the asset, rather than the asset's full value.

Net Investment Income Tax (Medicare surtax)

This new tax went into effect on January 1, 2013 and is part of the Affordable Care Act of 2010. It is imposed on top of other income taxes.

The surtax kicks in when modified adjusted gross income (MAGI) is above $250,000 for joint returns and surviving spouses, $200,000 for heads of households and single taxpayers, and $125,000 for married filing separately. Notice that these thresholds are substantially lower than the thresholds for the 37% income tax rate and 20% tax rate on long term capital gain. We'll come back to this fact in the example below.

MAGI equals AGI plus any foreign earned income exclusion. Taxpayers below the MAGI thresholds do not pay any Medicare surtax. The rest of this discussion applies to donors who are above the applicable MAGI threshold.

The Medicare surtax has two parts. The first part is an extra .9% tax on wages and self-employment income above the thresholds. Just as there is no charitable planning against the current Medicare payroll tax, this extra .9% will have little effect on gift planning.

The second part is a 3.8% surtax called the Net Investment Income Tax or NIIT. This surtax is imposed on the lesser of (1) net investment income or (2) the amount by which a taxpayer's MAGI exceeds the applicable threshold.

Net investment income includes income or realized capital gain from stock, bonds, certificates of deposit and other passive sources such as annuities, rents, and royalties. It also includes income from life income gifts, such as gift annuities, charitable remainder trusts, and pooled income funds. It does not include qualified retirement plan distributions or gains from sales of an active business, S corporation, or partnership interest.

The Impact of State and Local Taxes

As of January 1, 2018, a maximum of $10,000 of state and local taxes may be claimed as itemized deductions on a federal income tax return. For taxpayers who have less than $10,000 in state and local taxes, their marginal income tax rate is less than the sum of their federal, state, and local income tax rates. For example, the combined marginal rate for such a taxpayer whose marginal rate is 24 percent for federal income tax purposes and 5 percent for state income tax purposes would not be 29 percent, which is the sum of the two rates. Rather, the effective rate would be 27.8 percent, computed as follows:

$.24 + ((1 - .24) \times .05) = .278 = 27.8$ percent

For taxpayers who have more than $10,000 in state and local taxes, their marginal income tax rate equals the sum of their federal, state, and local income tax rates.

A separate issue is whether a gift that results in a charitable deduction for federal income tax purposes will also result in a charitable deduction for state income tax purposes. Some states do not impose an income tax, so, naturally, a charitable deduction against income tax is irrelevant in those states. They are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. In addition, not all states are as generous as the federal government in connection with charitable gifts. In the past decade at least a dozen states have tinkered with the limitation or disallowance of their charitable deductions. Massachusetts doesn't allow any charitable deductions, for example.

III. The Income Tax Charitable Deduction

To encourage charitable giving, contributions to qualified charitable organizations are deductible for income tax purposes (as well as for gift and estate tax purposes, as noted later in these materials). Contributions must generally meet the conditions of Internal Revenue Code Section 170 to be deductible for income tax purposes. This Code section and the accompanying regulations address the types of charities eligible to receive deductible gifts, the kinds of property that can be donated, and the substantiation of charitable deductions.

Significantly, not all charitable gifts result in income tax deductions. For example, gifts made directly to individuals – no matter how great the need of the individual and no matter how pure the philanthropic motivation of the donor – are not deductible. The same is true for gifts to most foreign charitable organizations. Similarly, a donor may not be entitled to the deduction associated with a charitable gift until some point after the gift has been made. This can be the case with certain gifts of vehicles or with gifts of tangible personal property to a charitable remainder trust.

To be strictly accurate and for the purpose of providing definitions, a *charitable contribution* is the amount that a donor gives to charity. The income tax *deduction* a donor receives for making a charitable gift is the benefit that may be claimed on his or her income tax return (IRS Form 1040), provided that, among other things, the total of all itemized deductions – including any other charitable deductions available for the year in question – is more than the donor's applicable "standard deduction."

Deductions reduce, dollar-for-dollar, the amount of income subject to taxation. By contrast, an income tax *credit* reduces, dollar-for-dollar, the amount of tax owed. Unfortunately, no type of charitable gift produces an income tax credit. If the gift is made other than outright, the amount of the contribution equals the amount transferred minus the value of the income stream or other non-charitable aspect of the arrangement. For example, if a donor funds a charitable remainder unitrust with $100,000 and the present value of the payments to be made to the trust's income beneficiaries is $60,000, the donor's contribution will be $100,000 - $60,000 or $40,000, not the entire $100,000.

The Value of the Income Tax Deduction

The income tax deduction may be considered a rebate of the taxes associated with income equal to the value of the assets contributed to charity. An example is useful to understand how this works. In the case of Ted and Alice (example on page 2), if $10,000 of the itemized deductions they claim are charitable deductions, what is the value of that portion of their overall total of $40,000 in income tax deductions? The tax benefit of the charitable deductions is equal to $10,000 multiplied by Ted and Alice's marginal tax rate of 24%, i.e., $2,400. Another way of looking at it is that if they had not made the $10,000 worth of gifts, they would have paid $2,400 more in taxes ($41,379 instead of $38,979). Yet another way of looking at the situation is that it cost them $7,600 to make charitable gifts totaling $10,000.

Note: Sometimes a charitable deduction will save money in taxes at more than one rate. Taking once again the case of Ted and Alice, if the total of their deductions had been $100,000, rather than $40,000, and if their charitable deductions had totaled $70,000, rather than $10,000, most of the tax savings associated with their charitable giving would have been at the 24-percent rate, but the rest would have been at a 22-percent rate. In this situation, their tax savings per dollar given would be a little less than the 24 cents per dollar they save when their total deductions are $40,000 and their charitable deductions are $10,000.

Deduction Reductions (the "Pease" Rule)

The so-called "Pease limitation" reduced itemized deductions by 3% of the amount by which a donor's adjusted gross income exceeded a threshold amount. This limitation was eliminated by the 2017 Tax Act.

Determining the Size of the Deduction Associated with Donating an Asset to Charity

There are a number of limitations on a taxpayer's ability to take advantage of income tax deductions associated with charitable gifts. The point is that a taxpayer may not reduce his or her tax liability to zero based solely on claiming such deductions.

There are three factors to consider when calculating the income tax charitable deduction attributable to a particular charitable gift. First, what type of property is being donated? Second, how long has the donor held the property? Third, if the property is tangible personal property, will the charity use the property in a way related to the charity's mission? In addition, a fourth consideration already touched on earlier is whether the gift is arranged in a manner that results in some benefit (e.g., a stream of payments for life) being received by any person or entity other than a charity.

The table below summarizes those rules as they apply to public charities, pass-through foundations, and private operating foundations:

Type of Property	**Deductible Amount**
Cash	Face amount
Securities and real estate - owned over one year	Fair market value
Securities and real estate - owned one year or less	Cost basis or fair market value, whichever is less
Tangible personal property:	
"Related Use" owned over one year	Fair market value
"Related Use" owned one year or less	Cost basis or fair market value, whichever is less
"Unrelated Use" regardless of how long owned	Cost basis or fair market value, whichever is less
Inventory (excluding inventory contributed for research and other special cases)	Cost basis or fair market value, whichever is less

A Note about Private Foundations

Private operating foundations engage in activities in addition to grant making. For example, a private foundation dedicated to environmental causes that conducts educational programs on protecting the environment would be an operating foundation.

A private foundation that engages only in grant making is considered a non-operating foundation. The rules are much more restrictive for gifts to private non-operating foundations, which include most family foundations. The amount of the deduction to a private non-operating foundation is the face amount for cash and the fair market value for publicly-traded securities, but for all other property the deduction is limited to cost basis (or fair market value if less than cost basis). Thus, gifts of tangible personal property and real estate are treated less favorably when made to a private non-operating foundation than when made to a public charity or a private operating foundation.

Amount of the Deduction a Donor May Claim Each Year

The amount of the charitable deduction that can actually be used in any one year depends on two variables: the type of property donated and the type of organization that benefits from the gift. If, based on the application of these two criteria, the entire deduction cannot be reported in the year the gift is made, the donor has as many as five carryover years in which to use it. Carryovers apply in connection with gifts to private non-operating foundations as well as to public charities and operating foundations.

The table below summarizes the rules relating to deductibility by type of organization and type of property donated:

Type of Organization	Examples	Type of Property	Deductibility
Public charities and private operating foundations. Sometimes called "50% Charities."	Educational institutions, churches, tax-exempt hospitals, governmental units, publicly supported organizations such as the American Red Cross or a symphony orchestra, along with private operating foundations.	Cash	60% of AGI
		Ordinary Income, non-appreciated property	50% of AGI
		Long-term Capital Gain Property	30% of AGI
Private non-operating foundations. Sometimes called "30% Charities."	Strictly "grant making" foundations.	Cash and Ordinary Income Property	30% of AGI
		Long-term Capital Gain Property	20% of AGI

Example: *Bob and Carol have an AGI of $350,000. They are considering donating to an art museum publicly-traded stock worth $700,000 that they bought several years ago for $400,000. Since these shares of stock are appreciated publicly-traded securities held for more than one year, Bob and Carol would be entitled to a deduction for the full fair market value of the stock and would completely avoid being taxed on any of $300,000 of long-term capital gain.*

Nevertheless, precisely because the securities are a long-term appreciated asset, Bob and Carol would be able to claim in the year of the gift only $105,000 (i.e., 30% of $350,000) of the $700,000 deduction. Assuming their AGI remained at $350,000 in each of the following five years and that they make no other charitable gifts during this period, they would be able to deduct a total of $630,000 in the year of the gift plus the five carryover years (6 x $105,000=$630,000). They will not be able to use $70,000 of their $700,000 deduction.

What if instead of donating publicly-traded securities, Bob and Carol donated $700,000 cash to the museum? Because of the increased ability to claim a deduction associated with a gift of cash (60% of AGI) versus long-term appreciated property (30% of AGI), they will be able to enjoy the full benefit of their income tax charitable deduction. They will be able to deduct $210,000 dollars a year (60% of $350,000) and use their entire $700,000 deduction in four years - $210,000 in each of the first 3 years and $70,000 in year 4 - again assuming their AGI was $350,000 in each of the following three years and that they make no other charitable gifts during this period.

Let's now assume that instead of contributing publicly-traded securities, Bob and Carol donated to the museum $700,000 in artwork with a cost basis of $250,000. In this case, the rules governing gifts of tangible personal property apply. If the museum displays the artwork in its galleries or otherwise uses it to further the museum's charitable mission, the gift will be deemed for a "related use" and the donors will be entitled to a deduction for the full fair market value of their artwork, $700,000, and the deduction can be claimed up to a limit of 30% of AGI. If the museum instead sells the artwork upon receipt, the gift will be deemed for an "unrelated use" and the deduction Bob and Carol receive will be limited to their cost basis of $250,000, although this deduction could be claimed up to a limit of 50% of AGI.

How the 60% and 30% limitations interact

Cash contributions reduce, dollar for dollar, the limit on 50% deductions taken in the same tax year, whether current gifts or carryforward. They also reduce this 50% limit when considering the 30% limit on gifts of long term appreciated property. The result is that the only way a donor can deduct more than 50% of her AGI in charitable contributions is if the contributions deducted are made entirely with cash.

***Example**: Manuela has an AGI of $100,000 and makes $40,000 of cash contributions and $20,000 of long term appreciated property contributions. She can deduct all $40,000 of her cash contributions, but only $10,000 of her long term appreciated property contributions because the 50% limit within which the 30% is applied has been reduced to $10,000 by her $40,000 in cash contributions ($50,000 - $40,000 = $10,000). Her total deductions will be $50,000 and she'll carry forward $10,000 of 30% long term gain contribution.*

Order of Priority of Deductions

The deductibility projections in the example above do not account for the fact that Bob and Carol may have made prior charitable gifts that they are carrying over. They may well also make additional charitable contributions – either in the year of their gift to the museum or in future years – that will affect their ability to claim the deduction associated with whatever gift to the museum they actually make.

There are certain ordering rules provided by the IRS that guide a taxpayer as to how past and future deductibility will be netted against current contributions. The table below summarizes those rules from IRS Publication 526:

1. current contributions of cash to "50% charities."
2. carryover contributions of cash to "50%" charities."
3. current contributions of non-appreciated property to "50% charities."
4. carryover contributions of non-appreciated property to "50% charities."
5. current contributions of long-term capital gain property to "50% charities."
6. carryover contributions of long-term capital gain property to "50% charities."
7. current contributions of cash and non-appreciated property to "30% charities" as well as contributions of such property "for the use of" "50% charities."
8. carryover contributions of cash and non-appreciated property to "30% charities" as well as contributions of such property "for the use of" "50% charities."
9. current contributions of long-term capital gain property to "30% charities" as well as contributions of such property "for the use of" "50% charities."
10. carryover contributions of long-term capital gain property to "30% charities" as well as contributions of such property "for the use of" "50% charities."

<u>Special Election</u>

A donor may elect to have his or her contribution of long-term appreciated property come under the 50%-of-AGI ceiling, rather than 30% ceiling, by reducing the total allowable deduction to the property's cost basis. The reduction must be applied to (1) all long-term property gifts for the current year, and (2) all prior year long-term property gifts for which a deduction is being carried forward.

Such an election may be advantageous if (1) the total appreciation is small, (2) the donor probably would not be able to use the deduction over the course of as many as six years, or (3) the donor expects to be in a higher bracket this year than in subsequent years.

<u>Charitable IRA Rollover</u>

The Charitable IRA rollover enables qualifying donors to transfer funds from their traditional IRA or Roth IRA directly to a public charity without recognizing any income from the withdrawal or receiving a deduction. Because the donor doesn't declare the withdrawal as income on his or her tax return, a Charitable IRA rollover never results in additional income tax for the donor. When available, this giving technique has been a popular method for making charitable gifts. Congress finally made the Charitable IRA rollover permanent in late 2015.

Below are the key provisions of the Charitable IRA rollover as it is today:

- Rollovers will count towards the required minimum distributions (RMD) from an IRA, and they will not be included in the taxable income of the donor.
- The donor is age 70½ or older.
- The gift is made to a public charity and not to a private foundation or supporting organization.
- The gift is not made to a donor advised fund maintained by a charity;
- The donor receives no benefit in exchange for the gift. (This rules out gifts for life income arrangements.)
- The gift, combined with other qualifying IRA charitable rollover gifts made during the year, does not result in the total of such gifts exceeding $100,000.
- The donor must have documentation from the charity that the distribution was received and that he or she received no benefits.
- The rollover can be made only from an IRA. Rollovers from 401(k) and 403(b) plans would be treated as taxable distributions. A donor could roll assets from these plans into an IRA and subsequently authorize a distribution to charity from the IRA.
- Funds transferred per the charitable IRA rollover can fulfill a pledge to the charity.

There have been efforts in Congress to expand the Charitable IRA rollover to include transfers to foundations and donor advised funds or to certain life income plans with certain payout rates and amount limitations. There is no indication that Congress is likely to expand the Charitable IRA rollover in these ways anytime soon.

IV. When Is a Charitable Gift Complete?

The Regulations to the Internal Revenue Code tell us that “A gift is complete when the donor relinquishes dominion and control over the gift asset.” Reg. Sec. 1.170A-1(b). However, establishing when the donor has surrendered control of an asset can be complicated. A charity should consider two things when determining when a donor’s gift is complete: what type of property was donated and how was it delivered to the charity?

Gift by Check

A gift of a check is complete on the later of (a) the day the check is dated and (b) the day the check is hand delivered or mailed. Unless another date can be established, the date on the postmark is the date that it was mailed. If a check post-dated to January 10, 2016 is mailed on December 30, 2015, the gift is complete on January 10, 2016.

If a check is dated December 30, 2015 but mailed on January 5, 2016, the gift is complete on January 5, 2016. If a check is both dated and mailed on December 30, 2015, but clears on January 3, 2016, the gift is complete on December 30, 2015.

Gift by Credit Card

A credit card gift is complete on the day when the charge is made, regardless of when payment for the charge is made.

Gift of Stock

In the case of a properly-endorsed stock certificate (or an unendorsed stock certificate and a properly-signed stock power), the gift is complete when the documents are hand delivered or mailed. Again, the default date of mailing is the date on the postmark.

In the case of stock held in a brokerage account (i.e., "in street name"), the gift is complete when the stock is actually received in the charity's account (i.e., when ownership of the stock is changed on the broker's records), not when the donor gives transfer instructions to his or her broker.

In the event a donor asks the transfer agent for the company issuing the stock to transfer X number of shares to the charity by issuing a new certificate registered in the charity's name, the gift is complete on the date that appears on the certificate. (Note: This method of transferring stock is generally not advisable because the transfer could take a few weeks, and stock values may have changed considerably in the meantime.)

Gift of Real Estate

The date of a gift of real estate depends on the law of the state where the property is located. In almost all states, the gift is complete upon the delivery (applying the same criteria as in the case of a cash gift) of a properly executed deed. The completion date is this delivery date, not the date when the deed is recorded, which will often be later.

Gift of Tangible Personal Property

A gift of tangible personal property is complete on the later of the date when (a) a deed of gift has been executed and (b) the object has been physically transferred to the charity.

Charitable IRA Rollover

The completion date for a charitable IRA rollover is not important for claiming a charitable deduction, because no deduction is awarded. But it is important for the calculation of the RMD for the year and for staying inside the $100,000 limit. Presumably, the mailbox rule would apply here. If the IRA administrator transfers cash or mails a check before year-end, that would permit counting the rollover gift in that calendar year, regardless of when it arrives at the charity.

V. Valuation of Securities

In the case of publicly-traded securities, the deduction is the mean between the "high" and the "low" trading prices on the date of the gift. For securities sold over the counter, it is the mean between the "bid" and "ask" prices. In other words, the deduction is the average worth of the securities on the day they are relinquished. *It does not depend on the closing price or on the net proceeds actually received by the charity when the securities are sold.*

In the case of thinly-traded securities, i.e., those for which sales do not necessarily occur every day, the gift value is a weighted average of the value on the last trade date before the gift date and the value on the first trade date after the gift date.

The valuation of some securities – such as certain municipal bonds, local bank stock, and closely-held stock – is not based on market activity and thus may not be readily ascertainable. A broker can usually obtain market values of bonds and bank stock. Closely-held stock presents a different set of problems and must be valued by a qualified appraiser taking into consideration a number of factors about the company.

Mutual fund shares, if traded on a stock exchange, are valued in the same manner as shares of stock. For mutual funds which can be owned only through maintaining an account with the company that operates the fund, the value will be based on the closing net asset value on the date of gift.

VI. Substantiation of Charitable Gifts

A charitable organization is required to provide donors with substantiation for charitable gifts to the organization. The type of documentation required depends upon the amount of the gift and the type of property donated.

A. Gift Receipts

<u>Gift of $250 or More, no Goods or Services Furnished to the Donor in Return</u>

If a donor makes a gift of $250 or more to charity, the donor must obtain a receipt to support the deduction. A canceled check will be insufficient.

In these cases, the receipt provided by the charity must state that no goods or services were provided to the donor (see below if there were). The $250 threshold applies to each particular gift, rather than to the total amount of all gifts made to a charity during the year.

<u>Gift of $75 or More, Goods or Services Furnished to the Donor</u>

If a donor makes a gift of $75 or more to a charity that provided goods or services to the donor in exchange for the gift, the charity is required to provide a receipt, informing the donor of the amount of the contribution that is deductible.

Exceptions to Disclosure Requirements
Token benefits– Goods or services that have “insubstantial value” as defined by the IRS do not reduce a donor’s deduction and need not be disclosed by the charitable

organization. The amount considered of insubstantial value is adjusted annually for inflation. For calendar year 2018, these "low cost articles" are those whose value is not more than two percent of the donor's gift or $109, whichever is less, or when the payment is at least $54.50 and the only benefits received are token items such as mugs, calendars etc., bearing the organization's name or logo. These token items are deemed to be "low cost articles" if their cost (as opposed to their fair market value) does not exceed $10.90, in the aggregate, for all items received by the donor during that year.

If the benefits exceed these *de minimis* limits, the receipt must provide a good faith estimate of the value of those benefits and indicate the deductible amount.

Failure to provide the required information can subject the charity to penalties – $10 per contribution and up to $5,000 per fundraising event.

B. Substantiation of Noncash Gifts

A donor must file IRS Form 8283 if the total value of all noncash property used to make a gift exceeds $500. Depending on the value and type of property contributed, the donor may need to complete Section A of the form, Section B of the form, or both sections.

<u>Section A Gifts</u>

Section A of Form 8283 must be completed if the donor is contributing publicly-traded securities valued in excess of $500 or closely-held securities, real estate or tangible personal property (paintings, boats, etc.) valued in excess of $500 but not more than $5,000.

<u>Section B Gifts</u>

Section B of Form 8283 must be completed if the donor is contributing closely-held securities, real estate or tangible personal property valued in excess of $5,000. Section B must also be completed if the aggregate claimed value of all similar items exceeds $5,000, even if the value of each single item is less than $5,000

After completing the Form and before attaching it to his or her tax return, the donor should have it countersigned by the charity to acknowledge receipt of the property and to commit to the filing of IRS Form 8282 if the charity sells or otherwise disposes of the property within three years of the gift.

<u>Qualified Appraisal</u>

To receive a charitable deduction for a Section B gift, the donor must obtain a qualified appraisal, in addition to attaching Form 8283 to the tax return on which the deduction is first claimed. Note: gifts of closely-held securities valued in excess of $500 but not more than $10,000 must be reported in Section B, but do not require a qualified appraisal.

A qualified appraisal is one that is completed not earlier than 60 days prior to the date of the gift (but no later than the due date – plus extensions – for the Form 1040 on which the deduction is being claimed) and is prepared by a qualified appraiser, that is to say, someone professionally qualified to value the type of property being appraised. The appraiser should be someone independent of both the donor and donee. The appraisal cannot be done by anyone affiliated with the charity, whatever his or her qualifications.

A qualified appraisal must not involve a prohibited type of appraisal fee. The fee should not be based on a percentage of the appraised value of the property. Rather, it should be a flat charge based on the time and expenses of the appraiser. PG Calc performs these types of appraisals in the specific case where a beneficiary relinquishes his/her right to receive income from a life income gift and the value of the beneficiary's income interest exceeds $5,000.

If the charitable deduction claimed is over $500,000, the qualified appraisal must be attached to the donor's tax return.

Schedule A of IRS Form 1040

If a donor is itemizing his or her deductions, he or she must file IRS Form 1040 (rather than one of the other income tax returns, such as Form 1040-A or Form 1040-EZ). Itemized deductions are listed on Schedule A. As noted above, if the donor has made an outright non-cash gift valued at over $500, the donor should attach a completed Form 8283.

For irrevocable deferred gifts, just as with outright gifts, the donor should also include a completed Form 8283 if the gift was made with an asset other than cash and the deduction is more than $500. Schedule A should also be accompanied by a sheet showing how the deduction was calculated and a copy of the gift instrument.

VII. Gift, Estate, and Generation-Skipping Transfer Taxation

The federal gift tax is levied on the right of a person to transfer property during life. The amount of the tax – which is paid by the giver of the gift, rather than by the recipient – depends in part on the size of the gift, taking into account any other gifts the giver has made during his or her lifetime. It also depends on the identity of the recipient. For example, payments made on behalf of another person for tuition or medical care are exempt from gift tax if made directly to the educational or health institution in question.

The federal estate tax is levied on the right to transmit property at death. Using IRS Form 706, the amount of tax depends on the size of the estate the deceased leaves (as augmented by any taxable gifts made by the person during life and decreased by various deductions and exemptions), adjusted for any gift tax paid by the person during life. Many assets in which a person might have an interest upon death are considered part of his or her estate. Examples include the face amount of a life insurance policy owned by the person upon death (this despite the fact that such amount thereupon becomes payable to someone other than the owner) and half of any property jointly owned with a spouse.

The generation-skipping transfer tax (GST tax) tax is assessed on certain transfers of assets from an individual to one or more "skip persons," regardless of whether such transfers occur during the individual's life or upon his or her death. This tax is assessed *in addition to* gift or estate tax. Its purpose is to prevent skip persons from receiving assets free of gift or estate tax that otherwise would be subject to one of these two taxes.

Transfer Taxes under the 2017 Tax Act

The 2017 Tax Act passed by Congress on December 22, 2017 made one important change to the federal taxation of transfers during life and at death: it doubled the exemption from these taxes. Before the Act, this amount was going to be $5.6 million per person and $11.2 million per married couple. After the Act, this amount is $11.18 million per person and $22.36 million per couple. This means that a person can make a total of up to $11.18 million in taxable transfers to other people during life and at death without owing any gift or estate tax. A married couple can transfer a total of twice that amount - $22.36 million – without owing any gift or estate tax. These amounts are indexed annually for inflation, so they are likely to increase in future years.

It is estimated that only 0.1% of all estates will pay any federal estate tax. The federal tax rate for gift, estate, and generation skipping tax is 40%, so the tax can be substantial for the very few wealthy enough to owe it.

The GST tax exemption is also $11.18 million per person, as indexed for inflation in 2018, but it is a separate exemption from the unified exemption for gift and estate tax.

The provision in the 2017 Tax Act that doubled the exemptions for gift and estate tax, and GST tax will expire on December 31, 2025. Unless this provision is extended by Congress, these exemptions will return to the amounts under prior law after that date.

Transfer Tax Schedule

As shown in the table below, the gift and estate tax schedule is ostensibly progressive. However, as a practical matter the top rate of 40% is the only rate that taxpayers and their estates actually pay. Why? Because the unified exemption amount in 2018 of $11.18 million is far greater than the taxable transfer at which the 40% top rate starts. As a result, every dollar on which gift or estate tax is due is taxed at 40%.

Gift and Estate Tax Rate Schedule in 2018

Taxable Transfer	Tax	% on Excess
0	0	18
10,000	1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	40

Gift Taxes

The gift tax is a federal transfer tax that is assessed on an individual who transfers assets to another individual during life. The tax is computed using the Gift and Estate Tax Schedule applicable in the year of transfer and with reference to the donor's annual gift tax exclusion and available gift tax credit. Retention of control by the donor can make a gift incomplete and therefore not subject to gift tax.

The gift tax is cumulative. If a gift tax is due, it is usually payable by the taxpayer making the gift.

Exclusions from gift tax

Annual Gift Tax Exclusion - An individual may give another individual up to $15,000 in cash or property *each year* without having to report the gift or incurring a gift tax. There is no limit to the number of individuals to whom such gifts may be made. Husbands and wives may join together ("gift-splitting") and give up to $30,000 to any individual without making a taxable gift. To qualify for the annual exclusion, the gifts must be present-interest gifts. That is, the donee must have a right to benefit from the property immediately.

The annual exclusion is adjusted for inflation in increments of $1,000. Because inflation has been relatively low in recent years, the exclusion amount has increased only every three to four years. It increased from $14,000 to $15,000 in 2018, so it is likely to remain $15,000 for several more years.

Gift tax marital deduction - With the exception of certain gifts of future interests, gifts between U.S. citizen spouses are not subject to gift tax, whatever the amount. In this case, there is an unlimited marital deduction. If the donee spouse is not a U.S. citizen, however, there is an annual exclusion of $152,000 in 2018 on the amount the donor spouse can give the donee spouse during life without beginning to incur possible gift tax liability. This annual exclusion amount is indexed for inflation each year.

Qualified transfers - Payments made directly to service providers for tuition or medical care are not considered taxable transfers for purposes of gift taxes. These payments must be made directly to an educational institution or medical provider to be considered qualified transfers.

Example
The unified nature of gift and estate taxes makes the calculation of taxable transfers dependent not just on the transfer at any given point, but prior taxable transfers as well. That is because the calculation of transfer taxes is cumulative.

Suppose Mr. Soto made his first taxable gift with a gift of $700,000 to his son in 2002, the maximum he could then transfer without owing any gift tax. In 2018, Mr. Soto made another gift to his son, this time for the exemption amount available to him in 2018: $11,180,000. He had made no taxable gifts other than these two to his son.

In 2018, Mr. Soto owed gift tax of $280,000, computed as follows:

Taxable gift made in 2018	*$11,180,000*
Prior taxable gifts	*+ $700,000*
Cumulative lifetime taxable gifts	*$11,880,000*
Tentative tax on $11,880,000	*$4,697,800*
Less prior gift taxes paid	*- $0*
Less tax on 2018 exemption of $11,180,000	*- $4,417,800*
Gift tax owed	*$280,000*

Estate taxes
The estate tax is assessed on the assets in a person's estate after the person dies. The federal estate tax is assessed against a person's taxable estate, as determined on the federal estate tax return (Form 706). If a net estate tax is due, it is usually payable by the estate of the deceased taxpayer.

Gross Estate - The total value of a person's estate before any deductions are made for taxes, funeral expenses, attorney's fees or administration costs. The proceeds of life insurance are included in the gross estate if the policies were owned or controlled by the decedent. One half of property owned jointly with the spouse is included.

Basis step-up - Appreciated assets passing to heirs are entitled to a step-up in basis upon the death of the decedent. This step-up increases the cost basis of assets inherited upon the owner's death to their value on the date of death. The step-up in basis erases the potential capital gain associated with an appreciated asset up to the decedent's date of death. If the heirs subsequently sell the property, the taxable gain is calculated based on the increase in fair market value since the time of death, not the increase in fair market value since the asset was purchased.

Estate tax marital deduction –The first spouse to die can leave an unlimited amount to the surviving spouse, who is a U.S. citizen, completely free of federal estate tax. The amount passing to the surviving spouse can qualify for this marital deduction if it is given outright or under certain approved trust arrangements. Property passing to a surviving spouse, who is not a U.S. citizen, is not eligible for the marital deduction, unless the property passes to the alien spouse through a qualified domestic trust (QDT).

Portability - A deceased spouse can elect in his will to transfer his unused gift and estate tax exemption to his surviving spouse. For example, if a spouse dies in 2018 and uses only $1 million of his gift and estate tax exemption, he can elect to transfer the remaining $10.18 million in exemption to his surviving spouse. She can now transfer $21.36 million, during life and through her estate, not "just" her own $11.18 million of exemption, before she must pay any gift or estate tax. This is known as "portability."

Deductibility of lifetime gifts to charity - A donor is allowed an unlimited gift tax charitable deduction for lifetime gifts to qualified charities. However, the donor is required to complete a Gift Tax Return Form 709 if a donor makes a gift of a future interest gift of any amount or a gift of a present interest of more than $15,000 where less than the entire value of the donated property qualifies for a gift tax charitable deduction (this can be the case with certain contributions for gift annuities, for example).

Deductibility of bequests to charity - A donor is allowed an unlimited estate tax charitable deduction. If the bequest is in the form of a charitable remainder trust with the surviving spouse as income beneficiary, the deduction is for the present value of the remainder interest. If a surviving spouse is the only income beneficiary, the combination of the marital deduction and charitable deduction will eliminate estate tax on the property.

Example
Mrs. Soto dies in 2016 and leaves all her assets to Mr. Soto. Mrs. Soto made no taxable gifts during her lifetime and there is no estate tax because of the unlimited marital deduction. In addition, Mrs. Soto's estate elects to port her $5,450,000 lifetime exemption to Mr. Soto. Mr. Soto dies in 2018 with an estate worth $8,000,000. As noted in the gift tax example above, he made taxable transfers (to his son) during his lifetime totaling $11,880,000 on which he paid $280,000 in gift tax.

If Mr. Soto leaves all his assets to his son, his estate would owe $220,000 in estate tax, computed as follows:

Estate in 2018	*$8,000,000*
Prior taxable gifts during life	*+ $11,880,000*
Taxable estate	*$19,880,000*
Tentative tax	*$7,897,800*
Less gift tax paid during life	*- $280,000*
Less tax on 2018 exemption of ($5,450,000 + 11,180,000)	*- $6,597,800*
Estate tax owed	*$1,020,000*

Mr. Soto could have eliminated his estate tax by making charitable gifts in his estate of $2,550,000 or more. His estate's tax calculation would look like this if he included in his estate plans charitable gifts totaling $2,550,000:

Estate in 2018	*$8,000,000*
Charitable gifts	***- $2,550,000***
Prior taxable gifts during life	*+ $11,880,000*
Taxable estate	*$17,330,000*
Tentative tax	*$6,877,800*
Less gift tax paid during life	*- $280,000*
Less tax on 2018 exemption of ($5,450,000 + 11,180,000)	*- $6,597,800*
Estate tax owed	*$0*

Significance of the GST Tax with Respect to Charitable Giving

Because the GST tax applies only to certain types of transfers to *individuals*, there is no need for a GST tax charitable deduction as such. Nevertheless, it is important for gift planners to keep in mind that some gifts can have GST tax consequences for donors. As mentioned previously, gift tax or estate tax may also need to be paid in connection with any gift arrangement that is partly charitable and partly non-charitable.

If an individual beneficiary is a lineal descendant belonging to a generation two or more generations below the transferor (or someone other than a lineal descendant who is at least 37.5 years younger than the transferor), the beneficiary will be considered a skip person. There is an exception available in the case of a lineal descendant skip person if all members of the intervening generation(s) have died prior to establishment of the gift arrangement. For example, a charitable lead trust that terminates in favor of a donor's grandchild is not subject to GST tax if it was funded after the donor's child who parented the grandchild has died.

There are three kinds of generation skips:

Direct Skip
A direct skip occurs when a transfer subject to GST tax is made directly from the donor to the skip person during the donor's life or by will. The donor pays GST tax if the transfer is made during the donor's life, and the donor's estate pays the tax if the transfer is by will.

Taxable Distribution
A taxable distribution occurs when a transfer subject to GST tax is made to the skip person by means of a distribution from a trust (other than a distribution made in connection with a taxable termination – see below). A charitable remainder trust makes taxable distributions when it makes unitrust or annuity payments to a skip person, for example. The recipient of the distribution pays the tax.

Taxable Termination
A taxable termination occurs when a transfer subject to GST tax is made to the skip person at the termination of a trust. A charitable lead trust makes a taxable termination when it distributes its remaining corpus to a skip person, for example. The trust pays the tax.

No portability - Unlike unused gift and estate tax exemption, unused generation skipping tax exemption is not portable. Each spouse gets their own $11.18 million of GST exemption and that's it.

Impact of State Transfer Taxes

Twelve states have an estate tax. The details associated with such taxes – in terms of tax rates and amounts exempt from tax – vary considerably from state to state. In general, however, states that impose an estate tax allow a much lower exemption amount than the $11+ million available at the federal level. This means that far more estates in these states pay state estate tax than pay federal estate tax. On the other hand, those that do pay a state estate tax do so at a tax rate far lower than the federal rate of 40%. Exemptions range from $1 million to $5.49 million and tax rates range from 0.8% to 16%.

State estate taxes are deductible from federal estate taxes. Consequently, the combined federal and state estate tax rate faced by estates in states that impose an estate tax is somewhat less than the sum of the federal and state rates. For example, if an estate pays a marginal state estate tax rate of 10%, it's blended federal and state estate tax rate is 10% + (1 - 0.1) x 40% = 46%.

Six states - Iowa, Kentucky, Maryland, Nebraska, New Jersey and Pennsylvania – impose an inheritance tax on the recipients of an inheritance from a residence of that state (Maryland and New Jersey also impose an estate tax). The rates range from 4.5% - 18% and often surviving spouses, children, and grandchildren are exempt from the tax.

Very few states have a gift tax. No state has a GST tax.

Possible Income Tax Attributable to Transfers Made upon Death

If a person was either the owner or beneficiary of an asset that would have been a source of payments taxed to her as ordinary income, then that asset features Income in Respect of a Decedent (IRD). If, upon death, others become entitled to receive these previously untaxed amounts, these payments constitute IRD to the recipients.

A distribution from an IRA made after the IRA owner has died is a common example of IRD. The only exceptions are distributions from a Roth IRA or distributions attributable to contributions of after-tax dollars made by the decedent to a traditional IRA or other non-Roth type of IRA. The same is true of distributions from most qualified retirement plans after the owner's death. In the case of certain commercial annuity contracts and savings bonds, some of what is distributed will be IRD, with the rest being non-taxable principal.

The good news for charities is that because of their tax-exempt status no income tax will be due on any IRD they receive. This means that if a donor's estate plan calls for benefiting both individuals and charities upon death, it is most efficient from a tax standpoint for the donor's estate to use IRD assets to make charitable gifts, avoiding the income tax that otherwise would be owed on these assets, and to earmark other assets for individuals.

Example
Assume that $1,000,000 of Mr. Soto's $8,000,000 estate is from the balance in his qualified retirement plan. He can save $350,000 in total taxes on his estate's assets by using the $1,000,000 in his qualified plan to make charitable gifts and and pass other assets to his son. His son is in the 35% income tax bracket.

Estate tax	***Give IRD to Charity***	***Give IRD to Son***
Estate in 2018	*$8,000,000*	*$8,000,000*
Less charitable gifts	*- $1,000,000*	*- $1,000,000*
Prior taxable gifts during life	*+ $11,880,000*	*+ $11,880,000*
Taxable estate	*$18,880,000*	*$18,880,000*
Tentative tax	*$7,497,800*	*$7,497,800*
Less gift tax paid during life	*- $280,000*	*- $280,000*
Less tax on 2018 exemption of ($5,450,000 + 11,180,000)	*- $6,597,800*	*- $6,597,800*
Estate tax owed	*$620,000*	*$620,000*

Income tax		
Balance in qualified plan	*$1,000,000*	*$1,000,000*
Income tax deduction	*- $1,000,000*	*- $0*
Estate tax due on IRD	*- $0*	*- $400,000*
Taxable income	*$0*	*$600,000*
Income tax owed (son's rate=35%)	*$0*	*$210,000*
Total tax (estate tax + income tax)	***$620,000***	***$830,000***

Mr. Soto will save $210,000 in taxes by making $1 million in charitable gifts from his retirement plan rather than from other assets.

Mr. Soto will save taxes by making his charitable gifts from his retirement plan rather than other assets *even if his estate is not large enough to pay estate taxes.* This is because all the tax savings comes from avoiding the income tax that would be due on the $1 million in his retirement plan when his son withdrew it. In fact, his savings would be greater than in the example above because there would be no estate tax attributable to his retirement plan assets. As a result, all $1 million in his retirement plan would be taxable income rather than "just" $600,000 if he were to give this asset to his son. His son's tax savings would be $350,000 rather than $210,000.

IX. Conclusion

A basic understanding of the rules governing the federal income tax, as well as other types of taxes, will improve a gift planner's understanding of a donor's financial situation. In turn, this understanding can guide the planner in proposing a gift arrangement that is suitable for the donor. Furthermore, donors will often raise objections to making charitable gifts, based on aspects of their tax situations. A working knowledge of the tax rules can help the gift planner overcome these objections. Likewise, when a donor voluntarily discusses his or her tax situation with a gift planner, knowledge of the tax rules will serve the planner well in such conversations. Of course, if the planner is a representative of a charity, he or she will need to advise the donor to consult an independent tax advisor before making a gift.