PROBLEM SOLVING WITH PLANNED GIFTS

PG CALC WEBINAR

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Introduction

In planned giving marketing the focus is often on specific gift instruments or arrangements such as bequests, gift annuities, and the Charitable IRA Rollover. However, when we meet with prospective donors we are presented with a variety of information about the prospect's aspirations, financial situation, and family dynamics. Our challenge is then to propose the most appropriate plan, which might not be the one that prompted an initial inquiry by the prospect.

The following case studies are intended to stimulate thought as to which planned gift, or combination of planned gifts, might enable donors to solve problems and attain objectives. The approach is donor-centered rather than instrument-centered planned giving.

The list of cases that might be cited is endless. The ones presented here are just a sampling.

Case One

Problem

You call on a donor we will call Fred. He is a widower with an estate totaling $2 million. He tells you that he would like to leave 10% ($200,000) of his estate to your charity and the remaining 90%, in equal shares, to his two daughters. He asks how much he would save in estate taxes by doing this. You respond that there would be no estate tax savings because his estate value is below the current federal and state estate tax exemptions. Then you say that if he made his gift by naming your charity as beneficiary of his retirement fund, there could be income tax savings because retirement funds, if given to his daughters, would be fully taxable. Fred replies that all of his retirement funds are now in a Roth IRA, so his daughters would not be taxed on the distributions. You point out that, even though he would not save any taxes by making the gift, he would have the satisfaction of making a difference and setting an example for his daughters. He nods in agreement, but it is evident that he is disappointed, and you fear that he will not make the gift. Is there anything else you might have proposed to him?

Solution

You might propose to Fred that he give each daughter $1,000,000 instead of the $900,000 originally intended, and at the same time convey his wishes to his daughters that each of them contribute $100,000 to your charity. Assuming that each daughter is subject to a 33% income tax rate, she would save $33,000 in income tax over the period that she claims the deduction.

His daughters would be under no legal obligation to make the gifts. To qualify for an income tax deduction, they must have full control of the money and then make a gift as a free and voluntary act. However, they would have a moral obligation to fulfill the wishes of their father. Fred might say something like this to his daughters: "As you know, your mother and I were long-time supporters of ABC charity because we believed it provides a valuable service to people in this community. While both of us wanted most of our estate to go to your girls, we had talked about leaving 10% to ABC charity. I would like to do that in a way that saves taxes and thereby benefits you as well as the charity. Thus, I want to inform you that I have decided to leave each of you my entire estate in equal shares, and it is my wish that you would choose to contribute 10% of what you receive to ABC charity. You will be entitled to an income tax charitable deduction for the contribution, and the tax savings will indirectly add to your inheritance."

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This arrangement works where there is good communication and trust within the family. It effectively increases the inheritance of the children while fulfilling the parent's charitable intent. Discussion of the parent's wishes also provides an opportunity to teach family values to the children.

In the past, discussions of a charitable bequest often entailed estate tax savings. When the exemption was $600,000, or even $1 million, as it was at the beginning of the century, a large number of people could reduce estate taxes with a charitable bequest. Now, when the exemption is $5,340,000 only about .3% of donors realize any federal estate tax savings from a charitable bequest. If they live in a state that has a state estate tax, and the exemption level is lower than the federal exemption, they might save state estate taxes with a charitable bequest even if they would save no federal taxes. Still, for most people estate taxes are no longer a consideration in charitable legacy planning. Although the desire to make a difference is the primary reason people make legacy gifts, some are more inclined to arrange such gifts if they can reduce taxes by doing so. Showing them how to do this might be the tipping point for their decision.

Some gift planners might hesitate to mention the indirect legacy gift in their marketing material for fear that it would make expectancies less certain because family members might not necessarily follow through and actually make the contributions. They consider that being named in the donor's will or beneficiary form is more important than the inducement of a tax incentive. Even if they decide not to mention the idea in their literature, they can discuss it with philanthropic donors whose estates are below the exemption level and have the right family dynamic. When a charitable bequest will be made at the death of the first spouse, and no estate tax savings would result, you could also mention the possibility of having the surviving spouse make the gift.

Technically, a donor would not qualify for a charity's legacy society when the intended gift will be made by heirs. However, a charity could elect to offer membership in its legacy society based on a statement of intention by the family.

Case Two

Problem

In the above example, the tax savings resulting from a charitable bequest are realized by the donor's daughters. Is there any way the donor could realize the tax savings while still alive? Consider these two examples:

Maurice, age 88, has included a bequest of $100,000 to an arts organization in his will. He is in failing health with a heart problem and does not expect to live more than two or three years. He has a good income from retirement funds and investments, and he considers this income and his Medicare coverage to be sufficient for whatever medical care he requires.

Martha, age 83, has included a charitable bequest to an environmental organization in her will for 10% of her residual estate. If she were to die today, the charity would receive approximately $100,000. She does not expect to deplete her estate, but she is not absolutely sure whether she might need income from all of her assets.

The estates of both Maurice and Martha are too small to be subject to estate taxes.

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Solution
Maurice could make an outright contribution of $100,000 to the arts organization and then remove the bequest to it from his will. Since he is in a 33% tax bracket, he would save $33,000 in income tax, so his distributable estate would be enlarged. If he made his gift via the bequest, there would have been no tax savings.

Martha contributes $100,000 for a flexible deferred gift annuity reserving the right to begin payments anytime during the period 2015-2035. (She would be 104 in 2035.) She has no intention of every starting the payments. The option to do so is simply a safety net. She extended the possible payment-starting date to 2035 when she is 104 because she doesn't expect to live to that age and doesn't want payments beginning before death unless she specifically requests them. If she never needs the payments, the residuum from the gift annuity could be much larger than 10% of her estate value at the time of her death, and the deferred annuity, unlike the bequest provision, is irrevocable.

She receives an income tax charitable deduction of $58,236, which saves $16,306 in income tax. Although she doesn't have access to the principal as she would have with a bequest provision, she does have access to regular payments if she ever needs them. Again, there are tax savings that would not have resulted from a bequest.

Case Three

Problem
Your charity just received a check for $50,000 from John's IRA. Apparently, he was under the impression that the Charitable IRA Rollover had been extended, and he wanted your organization to have this money for its capital campaign without delay. Should you advise John that legislation renewing the Rollover provision has not been enacted, though you expect that it will be prior to the end of the year, most likely retroactive to January 1? And should you return the check to his IRA administrator or cash it and credit it to the campaign as he instructed you? In general what should we be telling people who are possibly interested in making gifts from their IRAs this year?

Solution
Definitely, you should inform John about the status of the legislation and of two possibilities if your charity proceeds to cash the check as instructed. The first is that the Charitable IRA Rollover will be extended retroactive to January 1, and because John's gift was made during the effective period, the distribution from his IRA to your charity will not be added to his taxable income. In this case, he will not be entitled to a deduction. The second possibility is that the Charitable IRA Rollover is not extended, in which case the distribution will be included in John's taxable income, and he will be able to deduct it subject to the normal contribution limit. In both cases the $50,000 will count towards his mandatory distribution requirement.

Assuming that he can deduct the entire gift, the deduction will offset the extra taxable income, and the net result will be the same as if the Rollover had been enacted. There is, of course, a possibility that, because of the loss of itemized deductions when income exceeds a certain level, because of the 50%-AGI limit on the use of contributions, and/or because a charitable deduction might not be allowed on the state income tax return in the state where John resides, the results

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would not be equivalent. However, they may be sufficiently similar for John to be content proceeding with the gift whatever the outcome of the legislation.

At this point, the charity should acknowledge receipt of the money, but not make any representation about the gift being deductible. Of course, it should also not make that representation for rollover gifts received after renewal of the Rollover legislation. Some IRA administrators may insist on withholding tax from the distribution pending renewal of the Rollover, though the donor may be able to opt out of the withholding.

Actually, contributing cash from his IRA is not necessarily the best alternative for John. Let's assume that he has appreciated stock with a fair market value of $50,000 and a cost basis of $10,000. He could contribute the stock, then withdraw $50,000 from his IRA and use the money to repurchase the stock, thereby offsetting the taxable distribution with the deduction and achieving a stepped-up basis in the stock. If he sells the stock after it rises in value to $70,000, he would be taxed on just $20,000 of the gain. If he had retained the stock and made his gift directly from his IRA, he would have been taxed on $60,000 of gain when he sells the stock for $70,000. If he did not want to hold on to the stock, he could have used the $50,000 to purchase different stocks and adjust his portfolio.

These interconnected actions enable John to satisfy part of his mandatory distribution requirement without taxation of IRA funds (a result he could also achieve with the Rollover if it is renewed), and it has the added benefit of avoiding tax on the capital gain in the stock, which under ATRA (American Taxpayer Relief Act) could be taxed at a higher rate than before. Since the contribution limit when appreciated property is contributed is 30% of AGI, John would need more overall income to use the entire deduction and thus offset the taxable distribution. Of course, the distribution would augment that income. The suggested option would be less appealing if his income is high enough to cause some loss of itemized deductions, or if he lives in a state where retirement fund distributions are subject to state income tax but no deduction is allowed for charitable gifts.

Although it is probably not a good idea to complicate matters by discussing this three-step procedure in planned giving literature, you should mention it to selected donors who would benefit from it. They will appreciate your creativity.

Case Four

Problem

Your donor, Marie, age 60, plans to start withdrawals from a well-funded retirement plan when she reaches 70, and she expects her income from that plan and other sources to be quite adequate. However, she would like to increase her income somewhat between age 62 when she plans to start reducing her working hours, and 70 when she plans complete retirement. She would also like to divest herself of some highly-appreciated stock that she thinks may not perform as well in the future. She purchased the stock for $40,000, and it is now worth $200,000.

You considered a term-of-years charitable remainder annuity trust, but the amount she would be contributing is below the $250,000 minimum required when your institution serves as trustee. Even if your organization would make an exception to the minimum, she would start receiving income two years before she is ready for it. You could propose a net-income unitrust that would

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convert ("flip") to a regular unitrust in two years, and for the first two years trust assets could be invested for growth with minimal net income. That might be acceptable to her, though she expressed a preference for a vehicle that would provide fixed payments. Is there any charitable instrument, other than a term-of-years charitable remainder trust, that would meet her objectives?

Solution
A commuted-payment gift annuity could be appropriate for her. This is a deferred gift annuity where life payments are commuted (exchanged) for payments for a certain number of years. According to IRC Sec. 514(c)(5), a gift annuity cannot be for a term of years or guarantee a minimum of maximum number of payments. However, the IRS in certain private letter rulings (e.g. 9042043, 9108021, 9527033, and 20023303) has approved gift annuity agreements that permit an exchange of life payments for a lump sum of for installments to be received during a limited period of time. The actuarial value of the installments must be the same as the actuarial value of the life payments.

In most instances, the commuted payment gift annuity has been used to provide educational expenses for a student attending a college or university, which is why it is often called "the college annuity." A grandparent might establish a gift annuity when a grandchild is young, stipulating that life payments begin when the grandchild is age 18. Then an authorized person commutes the life payments for eight semi-annual payments that can be paid at the beginning of each semester the grandchild is in college. The payments could be over a longer period to allow the grandchild more time to complete his or her degree(s). The installments will, of course, be much larger than life payments would have been. The charity would not have consented to an annuity for an annuitant of such a young age if payments were for life, but it will agree when it must make payments only for a reasonably short period of time.

The college annuity has the advantage of predictable payments for educational expenses, an income tax charitable deduction for the donor, and, of course, and a charitable gift. However, it has these disadvantages:

- Payments will be subject to a 10% penalty tax per IRC Sec. 72(q) because term payments start before age 59½.
- If the annuity is funded with appreciated property, the donor is taxed on part of the capital gain.
- Per the "kiddie tax," the taxable income may be taxed at the parent's highest bracket.

A charitable alternative that would avoid the first two of these disadvantages is a term-of- years net-income unitrust that converts to a regular unitrust when the student reaches age 18. Because this alternative is often preferable and because certain non-charitable plans, such as the "529" plan, may be a better way to fund a college education, it is probably not a good idea to promote the college annuity.

However, the commuted annuity could be very useful in other circumstances when a person wants fixed income for a certain period of time, and it is not practical to establish a term-certain charitable remainder trust. The contributed amount might be below the minimum required for a charitable remainder trust, or perhaps the donor likes the simplicity and assurance of a gift annuity.

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In the example above, Marie contributes her stock to the charity for a deferred gift annuity that will make quarterly payments to her for the rest of her life. Then she commutes those payments to quarterly installments for an eight-year period starting at age 62.

When she reaches 62, she will receive $24,974 per year ($6,243.50 per quarter) for eight years. She will also be entitled to an immediate income tax charitable deduction of $90,890, and the taxable gain can be reported over the payment period. From the charity's standpoint, it is much better to be able to use the residuum after only 10 years rather than waiting until the end of a 60-year-old's life.

Conclusion: Through a two-step process, it is possible to have a term-of-years gift annuity, and for some people who want payments for a certain period of time starting at a given future date, this can be preferable to a term of years charitable remainder annuity trust or unitrust.

Case Five

Problem

Your charity has an inactive pooled income fund with only three remaining beneficiaries and $45,000 of assets in the fund. The highest adjusted return during the past three years has been only 2.8%. You have been considering asking the three beneficiaries to contribute their income interests so that you can close the fund and save the costs of administering it. Would this be a wise course of action?

Solution

It is true that many pooled income funds have been terminated, and the majority of those that remain are dormant. Thus, it is understandable why a charity would want to close a nuisance pooled income fund and concentrate on gift annuities and charitable remainder trusts. However, for the following reasons you should consider reviving an inactive fund, or starting a new fund if you do not currently have one.

1. Pooled income fund gifts currently generate a much larger charitable deduction than gift annuities do.

   If a donor, age 65, contributes $100,000 for a gift annuity, paying the ACGA rate, and is the annuitant, the deduction, based on a 2.2% AFR (applicable federal rate), is $33,630. If the same donor contributes $100,000 to a pooled income fund, is the income beneficiary, and the highest adjusted rate of return over the past three years is 2.8%, the charitable deduction is $63,049.

   If the donor were to contribute the $100,000 to a newly-established pooled income fund, which this year would have a 1.4% deemed rate of return, the deduction would be $78,697. (In the case of a new fund, the deemed rate of return is the highest annual average AFR in the previous three calendar years less 1%, rounded to the nearest 0.2%.)

2. The payments from a pooled income fund, unlike those from a gift annuity, may increase over time. Presently, the payments from a gift annuity will usually be larger than from a pooled income fund, particularly if the fund is invested primarily in fixed-income securities. However, in the event that interest rates rise and/or dividends from stocks held

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by the fund increase, the payments from the pooled income fund could surpass those from the gift annuity.

3. Payments from a pooled income fund are not necessarily taxed less favorably than from a gift annuity. When a gift annuity is funded with cash, the payments are partly ordinary income and partly tax-free. When it is funded with long-term, appreciated securities, the payments are partly ordinary income and partly capital gain, and, in most cases, some portion will be tax-free.

   If the pooled income fund assets were all invested in fixed-income securities, the entire payment would be ordinary income taxed at the beneficiary’s highest marginal rate, so they would clearly be taxed less favorably than gift annuity payments. However, if the pooled income fun generates mostly dividends, taxed at the lower rate that also applies to capital gain, the total tax on the payments may not be larger than the tax on gift annuity payments.

4. Because the amount of income from a pooled income fund is not age dependent, younger donors find it attractive. Thus, it can be a good complement to a gift annuity program. Donors in their 70s and older would likely be more inclined to a gift annuity while those 60s and younger may find the pooled income fund more appealing.

5. The charity is not at financial risk with a pooled income fund as it is with gift annuities. Thus, it can be a way for risk-averse board members to offer a life-income vehicle to people who want to contribute more modest amounts and receive income.

6. A pooled income fund could be an alternative for charities that do not want to cope with the complex, and sometimes costly, registration requirements for offering gift annuities in certain states.

7. It is possible to design special-purpose pooled income funds. One example is a pooled income fund to help finance a building project. In addition to income, contributors receive the benefit of depreciation deductions passed through to them. Another example is a pooled fund which invests solely in social-purpose companies, whereby donors can simultaneously provide capital for projects that improve lives, make a gift to the charity that offers the fund, qualify for a significant charitable deduction, and receive a modest amount of income.

Conclusion: The solution to a comatose pooled income fund may be a shot of adrenaline rather than withdrawing life support, and charities without a pooled income fund may want to consider creating one.

Case Six

Problem

Sam and Rachel, ages 66 and 65, have invested well and have been able to accumulate an estate of approximately $18 million. They have a son, age 41, and a daughter age 39, both successful professionals. They also have two grandchildren from each child. During a conversation with you, they mention that they have four objectives:

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1. They would like for their children to enjoy some of their inheritance now while they are relatively young.

2. They want the children to have a very secure retirement with a good quality of life.

3. They want to provide college education funds for the grandchildren.

4. They would like for the children and grandchildren to develop a sense of community responsibility and have good values.

What would you recommend to them?

Solution
Sam and Rachel establish a charitable remainder unitrust and a charitable lead annuity trust, each funded with $4,000,000 of assets. The assets chosen for the unitrust are $1,600,000 of appreciated securities plus an apartment building appraised at $2,400,000 but with a low adjusted cost basis because they have been depreciating it. The unitrust has a 5.0% payout rate and will last for a term of 20 years. The two children are equal income beneficiaries. The assets chosen for the lead trust are securities that are believed to have significant growth potential. The payout rate of the lead trust is also 5.0%, and it too will last for 20 years.

The income from the lead trust will be distributed to a donor advised fund maintained by a community foundation. One-half of the remainder of the unitrust will be distributed to the community foundation to continue this donor advised fund, and the other one-half will establish an endowment named for the family at the university where Sam, Rachel and their daughter attended. Each year, Sam and Rachel plan to convene the children and grandchildren and jointly decide on the grants to be recommended to the community foundation. When they are no longer living, they hope this practice will be continued by their children and grandchildren.

Given the fact that Sam and Rachel are subject to a combined federal and state income tax rate of 44%, the charitable deduction of $1,456,280 generates income tax savings of $640,763.

They make two taxable gifts to the children: $2,543,720, which is the value of the income interest of the unitrust, and $791,960 which is the value of the remainder interest of the lead trust. The combined value of these two gifts is $3,335,680. That leaves $7,344,320 of their current combined gift/estate tax exemption of $10,680,000. ($5,340,000 + $5,340,000 - $3,335,680 = $7,344,320). They could make additional gifts to family members and other individuals totaling this amount without paying any gift or estate tax. The amount may well increase because the exemption is indexed for inflation.

Initially, each child will receive $100,000 per year from the unitrust, and if the trust corpus grows, their income will increase. If the lead trust were to have a constant net return of 7.0%, the principal would have grown to $7,279,639 by the time it is distributed to the children. The distributions to the donor advised fund will total $200,000 per year, and this will be available for family-recommended grants.

Sam and Rachel intend to create education trusts for the grandchildren. These trusts will not have a charitable component, and Sam and Rachel will some of their lifetime gift/estate tax

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exemption, as well as some of their generation-skipping-tax exemption, when they establish them. Even so, a considerable amount of their exemption will remain to cover future gifts to family members and other individuals. They might choose to make future gifts equal to their remaining exemption and give the balance to charity.

The plan meets all of their objectives and preserves enough wealth under their control to sustain their lifestyle. They have increased their children's current income and provided retirement security for them while leveraging their gift/estate tax exemptions. They also reduce their current income tax.

As the example of Sam and Rachel demonstrates, it sometimes makes sense to combine a charitable remainder trust and a charitable lead trust. Both family and charity receive a current income plus a future distribution.

In the Sam and Rachel example, the charitable remainder trust and charitable lead trust were concurrent. They could also be successive. A certain donor wanted to provide annual income to a medical school in honor of a son who was a professor there, and she also wanted to provide extra retirement security to her two granddaughters, who were children of the professor's brother, who, along with his wife, died in a private plane crash. This was accomplished by creating a 25-year lead trust and having the remainder of the charitable lead trust fund a charitable remainder trust that would pay income to the granddaughters for the rest of their lives.

Case Seven

Problem

Margaret, age 77, plans to move to a retirement community and sell the home in which she has resided for many years. An acquaintance is interested in purchasing the property, and to determine a fair selling price she recently had the property appraised. The value, as determined by the appraiser is $750,000, but her adjusted cost basis is only $200,000. She says that the acquaintance is willing to pay $750,000 for the property, though she has not yet entered into any purchase and sale agreement. She is aware that if she nets $750,000 from the sale, she can exempt only $250,000 of the capital gain from tax, and that she would have to pay tax on the remaining $300,000 of gain. Referring to an article she recently read in your charity's newsletter, she asks whether she could avoid paying tax on the capital gain by transferring the property to your charity in exchange for life payments, which she could use to cover a significant portion of her charges at the retirement home.

Solution

One possibility is to transfer the property to a charitable remainder unitrust. Normally, this would be a net-income unitrust that converts to a regular unitrust following the sale of the property, though a regular unitrust could be used from the beginning if there is a high degree of certainty that the property can be sold quickly.

When appreciated property is transferred to a charitable remainder trust, the donor is not taxed on the gain at the time of the transfer, and the trust is not taxed on the gain when the property is sold. However, to the extent that payments to the donor consist of gain realized by the trust, the donor will be taxed on that gain per the four-tier system for characterizing and taxing distributions. In other words, the gain realized upon sale of an asset by the trust sits in the trust as

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an accounting entrée and is taxed if and when distributed to the income beneficiary. The question is whether the $250,000 capital gain exclusion from the sale of a principal residence would reduce the capital gain on which Margaret could potentially be taxed under the four-tier system. Use of the exclusion would increase Margaret's basis in the property to $450,000, in which case the amount of gain that potentially could be taxed to her under the four-tier system would be reduced from $550,000 to $300,000. This may or may not make any practical difference since ordinary income items are distributed before capital gain under the four-tier system.

Suppose that Margaret prefers a gift annuity because of the certainty of payments. Even if a charity normally does not accept real estate for a gift annuity, it might in this case because a qualified buyer is waiting in the wings. If the property were given for a gift annuity and the charity pays the ACGA rate, Margaret would receive $46,500 per year, and an income tax charitable deduction of $354,247.

If Margaret were not entitled to a $250,000 exclusion of capital gain upon disposition of a principal residence (See IRC Sec. 121) she would be taxed on $290,218 of gain (the gain attributable to the present value of the annuity payments) and the portion of gain reported ratably each year of her life expectancy would be $26,155. How would the $250,000 exclusion reduce these numbers?

She could execute the normal gift annuity agreement, which states that the annuity is non-assignable except to the charity. Then each year she would apply $25,494 of her $250,000 exclusion until it is used up.

A possibly preferable alternative is to execute a gift annuity agreement that simply states that the annuity is assignable, not limiting the assignment to the charity. In that case $290.218 of gain will be recognized in the year of the gift. Gain cannot be ratably reported over life expectancy if the annuity is assignable to anyone other than the charity. (See Reg. Sec. 1.1011-2(a)(4)(ii)). The $250,000 would then be applied to the $290,218 of recognized gain, leaving $40,218 on which Margaret would be taxed. Because of her large deduction, she would still realize significant tax savings in the year of the gift. Since all of the gain would have been reported, a large portion of her future payments ($36,665) will be tax free. For determination of the taxation of payments, it will be as if she gave $750,000 of cash.

Conclusion: Gift planners almost always use a standard gift annuity agreement stating that the annuity is assignable only to the charity. This language is in prototype gift annuity agreements to assure that gain can be ratably reported over life expectancy when the donor is an annuitant. However, there are instances like this one where it is better to recognize all of the capital gain up front. That could be the case when a donor has a large available deduction.

Case Eight

Problem

Let's say that Margaret, in the previous example, tells you that she wants to use a portion of the proceeds from the sale of her home to pay the deposit on her unit in the retirement community. She would like to realize $150,000 for the deposit and receive income from the rest of the

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proceeds. Is this possible? If so, how would it affect the amount of gain that would be taxable to her?

Solution
She might contribute an undivided 80% fractional interest in the property, and retain a 20% undivided fractional interest. She and the trustee would be tenants-in-common prior to the sale. In this case, she will contribute the 80% fractional interest to a charitable remainder unitrust. Neither she nor someone related to her should serve as trustee, and the tenancy-in-common agreement should give the trustee full authority to manage the property prior to the sale and to negotiate the sale. If net sales proceeds are $750,000, they would be divided $150,000 to her and $600,000 to the trust. She would then use the $150,000 for her deposit. She would have to vacate the property no later than the date on which she creates the trust by signing the trust agreement and deeding the property to it. She cannot remain in the house temporarily and pay rent, for that would constitute a prohibited act of self-dealing.

To calculate the amount of taxable gain she recognizes, it is necessary first to allocate the basis between the fractional interest that she retains and sells and the fractional interest that she contributes to the trust.

The basis allocated to the 20% fractional interest that she retains and sells is $150,000/$750,000 multiplied by $200,000, which equals $40,000. The gain she recognizes upon sale of this fractional interest is $150,000 - $40,000 = $110,000. She could apply $110,000 of her $250,000 capital gain exclusion to this sale. The basis allocated to the 80% fractional interest transferred to the trust would be $160,000 ($600,000/$750,000 multiplied by $200,000). The gain that could be distributed to her under the four-tier system would be $300,000 ($600,000 – 160,000 – 140,000). The $140,000 in the calculation is the rest of the $250,000 exclusion.

If the payout of the trust is 6% and the AFR is 2.4%, her income tax charitable deduction would be $349,230.

Note: Even if the charity were willing, she could not transfer the entire property to the charity and receive from the charity $150,000 in cash plus annuity payments for life, for according to IRC Sec. 514(c)(5) the payments must be the sole consideration for the contribution. However, the payments would be the sole consideration if an 80% undivided fractional interest was contributed for the gift annuity. While a gift annuity funded with the fractional interest is possible, a charitable remainder trust is selected in this instance.

The appraiser of the property must be instructed to value the fractional interest that is to be contributed, and the appraiser might discount the value even though it is not a minority interest.

Many individuals reach a stage of life when they are ready to move from the family homestead to a retirement community, and they could be quite attracted to an arrangement whereby they generate cash for the deposit, receive life income to cover the monthly fee, reduce their income taxes, and make a gift to a favorite charity.

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Case Nine

Problem
Roger and Corrine, both in their late 70s, own a waterfront home, currently valued at about $4,000,000 with a cost basis of $1,200,000. The college for which you work is conducting a capital campaign, and you and a volunteer call on Roger and Corrine to ask them for a capital campaign gift of $1,000,000. This seems like a plausible request since Roger served on the college's governing board, and both he and Corrine have been extremely generous through the years. Roger tells you that they dare not contribute $1,000,000 of investments, for they need them for a secure retirement. Being very enterprising, you ask them about their plans for their residence, and they respond that they love the property and want to remain there for the balance of their lives, whereupon the survivor will give the property to their three children through his or her will. Not to be defeated, you ask if they would consider possibly giving 25% of the remainder of the residence to the college and 25% to each of the children. Roger and Corrine reply that they would consider doing this.

Solution
Is it even possible to give a portion of the remainder interest in a personal residence? Rev, Rul. 76-544 denied a deduction when only part of the remainder interest was given to the charity, citing IRC Sec. 2522(c)(2), which denies a deduction if a donor transfers an interest in property to the charity and retains an interest in the same property or transfers an interest in the same property to a non-charitable donee.

However, Rev. Rul. 76-544 was subsequently revoked. The revocation was based on the fact that the legislative history of a non-trust gift of the remainder interest in residences does not suggest that a charity must receive the entire remainder interest, and also on Rev. Ruling 83-158 in which the IRS had acquiesced in a judicial decision allowing a deduction when the remainder interest in a residence was given to four different charities The court found that there was no reason to conclude that any of the four charities would have been worse off if one or more of the co-tenants had been individuals rather than charitable organizations. Thus, in Rev. Rul. 87-37, which revoked Rev. Rul. 76-544, the IRS concluded that a contribution deduction is allowable when a portion of the remainder interest conveyed to the charity is in the form of a tenancy-in-common with an individual.

Based on this later ruling, it appears that what you proposed was permissible. One might wonder though why you didn't just suggest that they give the hospital foundation a 25% undivided fractional interest in the property through their wills. While you could have done that, the gift would not have been irrevocable, the donors would realize no income tax savings, and, depending on your campaign counting guidelines, campaign credit might not have been given for the gift arrangement.

Suppose that Roger and Corrine decide to give the college 25% of the remainder in their residence, retaining a life estate in that 25%, and they engage an appraiser to value the property. The appraiser is instructed to determine not only the fair market value of the entire property but also the land value, the useful life of the buildings, and salvage value. If the appraiser refuses to do this, claiming that he can determine only the fair market value of the property and perhaps the value of the land, based on comparable sales, can the charity calculate the value of the remainder

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interest using the default useful life and salvage value numbers embedded in the planned giving software? (PG Calc's default values: Depreciable portion is two-thirds of the entire property, salvage value is 25% of the value of the depreciable portion, and useful life is 45 years.)

This question applies not just to the Roger and Corrine gift but to any retained life estate gift. In actual practice, a number of gift planners do, in fact, use these default values. It is not known whether they are being questioned on IRS audits.

Another question is whether a gift of 25% of the remainder interest in Roger's and Corrine's residence would be worth less than 25% of the entire interest. In other words, should there be a fractional interest discount? The appraiser should be informed that he is, in fact, valuing a 25% interest.

Although execution of the Roger and Corrine gift entails these complications, conceptually making a gift of a portion of the remainder interest in a personal residence is possible and could appeal to people who want to realize current income tax savings while apportioning the property between charity and heirs.

In any case, gifts of remainder interests in personal residences are particularly appealing now because the charitable deduction is very high due to the low AFR. Charities with sufficient financial resources might also consider giving the remainder interest in exchange for a gift annuity. This is the "charitable reverse mortgage." In determining the amount of the annuity payments, the charity must make sure that the future value of annuity payments is well below what the charity expects to realize from the property when it is able to sell it.

Case Ten

Problem
You receive a telephone call from Betty, an 80-year-old donor to your hospital foundation's annual fund asking if you might come and meet with her. Upon checking the records, you find that Betty has been contributing $50 per year for the past five years. During the meeting Betty tells you that her younger son, now deceased, was treated at the hospital for pancreatic cancer, and that her late husband was also been a patient there following a heart attack. She is grateful for the quality of care they received, and she would like to leave a $200,000 bequest to the foundation that would create an endowment named for her husband and son who, were treated there. Susan tells her that this is, indeed, possible, and provides bequest language for such an endowment that she could take to her attorney. During the conversation, Betty tells you that she has another son, Richard, a very successful dentist, who has three children, and that she is leaving the balance of her $1,200,000 estate to him.

Two weeks later you receive a distraught call from Betty, who says that she told her son about her plans and that he "hit the ceiling." He recalled that his father had said many times that he wanted his money to stay in the family, and he reminded his mother that she had three grandchildren who would need help with college. He suggested that instead of a bequest, his mother make a one-time gift of $5,000 to the hospital foundation in memory of his father and brother. After relating this conversation with her son, Betty says that she has decided to give the $200,000 outright now and not tell her son about it, so the gift would not appear in her will. She

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also says that she has no other family and wants to maintain good relations with her son as she grows older.

A few days later you receive an angry telephone call from the son, who accuses you of pressuring his mother to make a gift she can ill afford, "Can't you see that my mother is old and confused and isn't fully aware of what she is doing? I am telling you to back off and stop messing with her. Otherwise, the next telephone call you receive will be from my lawyer." Betty had appeared to be completely lucid when she talked to you, though she was obviously intimidated by her son. Susan does not know whether the son is simply reacting to the bequest that she had discussed with Betty, or whether the son is making a preemptive strike because he surmises that his mother might be contemplating a lifetime gift.

What should you do?

Solution
You could accept a $200,000 outright gift from Betty, have her execute an endowment agreement, and simply not respond to her son. If her son becomes aware of the gift – and he may well learn about it because he will be paying closer attention to his mother's affairs and quizzing her – he may, in fact, take legal action charging you with undue influence. He might not prevail, but this could be very upsetting to Betty, and possibly result in bad publicity for you and your hospital foundation.

You could respond to the son requesting a meeting, either with him alone or with him and his mother together. Meeting alone with him would not be fair to Betty, for she is the donor, capable of making her own decision, and she would not want others making decisions for her. Sometimes, when children object to a gift, it is possible to show them how the gift could be designed to benefit family members as well charity. In a meeting with Betty and her son, you might, for example, propose a testamentary charitable remainder trust where the son would receive income and eventually the memorial endowment would be established. However, given the son's behavior, such a meeting, even if the son consented to it, could be very explosive and counterproductive.

You could tell Betty that you must remove yourself from further discussions of the gift because her son believes that you are pressuring her, and advise her to meet with an attorney to discuss her intentions and make whatever estate or gift arrangements she chooses. Be careful to record contemporaneously what you say to her and also reiterate the conversation in a letter to her. You might invite her to be in touch with you after she has completed any plans. You don't want her to feel rejected, and in the event she does make a legacy gift, you want her to be properly thanked.

In many cases the children of donors are quite supportive of their parents' gifts. In other cases they see your discussions of philanthropy with a parent as a direct threat to them. Some suggestions:

- Encourage donors to inform their children about legacy gifts and have a family discussion about them.

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- Sometimes a parent is alienated from a child and tells you that they are disinheriting the child and want to give everything to you. Never exploit alienation for your charity's benefit. To the extent you can, encourage reconciliation.

- Where there is concern about the financial impact on children but also a desire to make a gift, propose plans, such as testamentary charitable remainder trusts, gift annuities, charitable lead trusts, or wealth-replacement life insurance trusts where children benefit from the gift arrangement.

- When appropriate, offer to meet with donors together with their children.

- Include children in recognition events. Some charities allow legacy donors to invite children as guests at a legacy luncheon, and they may still invite the children after the donor has died. This helps encourage continuity of giving within the family.

Case Eleven

Problem

Lois, age 75, has good cash flow from substantial investments. At present, her after-tax income exceeds her expenses, and she is growing her net worth. While she expects this to continue, she cannot be absolutely certain. She would very much like to fund scholarships now while she is living so that she can meet scholarship recipients and follow their progress. You propose two options for her consideration.

The first is to make an outright contribution each year. The contribution the first year would be $20,000, and each year it would be increased by the same percentage by which tuition rises. The contribution would provide two partial scholarships. You assure Lois that if her cash flow decreases and she needs the money, she could suspend the contributions. You further propose that she include in her will a bequest of approximately $500,000 to assure that the scholarships will continue to be awarded in her name.

The other option you propose is to contribute $450,000 of assets for an endowment, and the distributions (based on the current 4.5% distribution percentage) would be enough for two partial scholarships. If the endowment increases in value, the distributions for the scholarships will correspondingly increase, with a good chance that they will keep pace with rising educational expenses. Lois is hesitant to forfeit irrevocably the income from this amount of money, but based on what she has told you, you think she would have ample assets for any contingency.

Besides the two alternatives you mentioned, is there possibly another one that you could have mentioned?

Solution

Lois might contribute $450,000 for a gift annuity, but authorize the university to retain the payments for scholarships until whatever time she directs the payments to be made to her. The payments will be reported on a Form 1099-R as if she were receiving them, but she will receive a charitable deduction for the amount of the payments, for she is, in fact, contributing them. The

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withholding arrangement merely avoids having to make a decision and write a check each time she receives a payment.

Suppose she contributes stock having a value of $450,000 and a cost basis of $300,000.

The amount available for annual scholarships is $26,100. The University initially awards two partial scholarships totaling $20,000, and it retains the rest. A portion of what is retained is used to increase the scholarship amount in successive years to keep pace with rising tuition. The amount not needed for this purpose will be added to the residuum of the annuity at the end of her life, and the total retained funds plus the residuum will form an endowment to assure continuation of the scholarships in Lois's name.

Lois receives an initial deduction of $205,974, and that will substantially reduce her income tax during the next several years.

Her payments will be taxed to her as follows during her life expectancy:

Tax-free	$13,119
Capital gain	6,560
Ordinary income	6,421

Since her annual deduction of $26,100 exceeds her taxable income, she will save some taxes each year for the duration of her life expectancy. If she outlives her expectancy and the payments become fully taxable, they will be offset by the deduction of an equivalent amount.

This alternative, which could be called a **Virtual Endowment** provides (1) current scholarships, (2) a future endowment to continue them, (3) significant up-front tax savings, (4) and the security of having personal access to the annuity payments if they are ever needed.

Case Twelve

Problem
Your social-service organization is trying to raise money for a new building, and you have approached your prime prospect for a naming gift in the amount of $4,000,000. You need the money now because construction is ready to begin, and you have reason to believe that your prospect has the capacity to give this amount. However, your prospect explains that because of his projected income and carryover charitable deductions, an additional $4,000,000 charitable deduction at the present time would be of little benefit to him. He would be in a position to start using additional deductions six or seven years from now. What do you recommend?

Solution
The donor could make an interest-free, demand loan of $4,000,000 to your charity. Once he is able to use additional deductions, he would start forgiving the loan. Each portion of the loan that is forgiven is equivalent to an outright gift and can be deducted.

The problem with this solution is that an interest-free loan to a charity in excess of $250,000 will result in imputed interest to the lender. In other words, he will be taxed on the phantom interest

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he does not receive, calculated at the applicable federal rate. (See Reg. Sec. 1.7872-5T(b)(9)) Since he is effectively contributing back to the charity the interest he would have received, he would receive a deduction for the amount of the interest. If he is able to use the entire deduction, he could make the interest-free loan at no cost. If he is maxed out on usable deductions, he might pay some extra taxes, but they should not be large.

That is because the imputed interest rate on a loan where the lender can demand payment at any time is currently very low.

The risk to the charity is that the lender could demand repayment at any time, so it should be sure of the lender's financial situation and intentions before entering into the transaction. The naming opportunity could be contingent on the loan's being forgiven. That would help assure that the donor performs as promised.

This example presupposes that the lender has $4,000,000 of cash to loan. If he loaned the charity appreciated securities, which the charity sold, and the lender could demand a cash payment at any time, the lender would be taxed on the gain.

Even if a donor expects to be repaid, an interest-free loan could be beneficial to the charity because it saves the interest it would have paid a financial institution for a loan.

Case Thirteen

Problem
Jim is the principal shareholder of an S corporation, which manufactures water purification devices, and you have asked him for a $500,000 outright campaign contribution. He says that the only way he could make a gift of this size is to give you stock in his company. Then he observes that Bill, a long-time employee, who is a minority shareholder, wants to acquire a larger interest in the company, and he thinks that Bill could obtain the financing to purchase the stock. You respond that your charity, a Sec. 501(c)(3) organization, is an eligible S stock shareholder, and that it would be willing to accept the closely-held S stock, particularly if there is an interested buyer. You also note that Jim would receive a charitable deduction for the appraised fair market value of the stock, and that he would not be taxed on the capital gain. There would be considerable gain since Jim's adjusted cost basis in the S stock is only $20,000. Is contributing the S stock, in fact, the best way for Jim to make his campaign gift?

Solution
Consider the consequences for Jim and your charity if he contributes the S stock, and then the charity sells it for $500,000 to Bill.

The appraiser determines that the entire company is worth $15,000,000, which means the contributed stock would constitute 3.33% of the outstanding stock. Because the contributed stock would be a minority interest, the appraiser discounts it by 20%, so the appraised value of the shares Jim would contribute is not $500,000 but rather $400,000. Moreover, because appraising a closely-held company is complicated, the appraiser charges $15,000 for the appraisal. The tax rate on Jim's and his wife's ordinary income is assumed to be 35%.

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Assuming that your charity then proceeds (without any pre-existing purchase and sale agreement) to sell the stock to Bill for $500,000, the charity will be taxed on the capital gain of $480,000 (See IRC Sec. 512(c)(1)(B)(ii).). If the charity is a corporation subject to a tax rate of 34%, it would pay tax of $163,200, leaving $336,800 of after-tax proceeds for your charity.

Consequences for Jim:

Tax savings from the deduction (35% x $400,000)	$140,000
Tax on capital gain	-0-
Appraisal fee	- 15,000
Net benefit	125,000
Net gift to your charity	$336,800

Now consider the consequences if Jim sells the stock to Bill for $500,000 and then makes a cash gift of $500,000 to your charity.

Consequences for Jim:

Tax savings from the deduction (35% x $500,000)	$175,000
Tax on capital gain (18.8% x $480,000)	- 90,240
Net benefit	$84,760
Net gift to your charity	$500,000

By decreasing his net tax benefit by $40,240 Jim is able to increase his charitable gift to your charity by $163,200. (The benefit to your charity could be larger if it is subject to a tax rate of less than 34%, which would be the case if it is structured as a trust rather than a corporation.)

Another benefit to Jim of selling the stock and giving cash is that he can realize the tax savings more quickly. The contribution limit will be 50% of adjusted gross income. If he gives the S stock, the limit will be 30% of adjusted gross income.

Conclusion: The conventional wisdom is that it is better for a donor to contribute long-term appreciated property than it is to sell the property and contribute the assets. That is almost always true in the case of publicly-traded C stock, but it might not be the case with a gift of S stock or certain other assets. Thus, encourage donors considering a gift of such assets to explore the alternatives with an accountant.

Concluding Word

The foregoing "solutions" utilize most of the planned giving instruments –bequests, gift annuities, pooled income funds, charitable remainder trusts, charitable lead trusts, retained life estate gifts, and outright gifts. What distinguishes these solutions is innovative adaptations and

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combinations of gift instruments in order to address particular donor situations. In other words, they are about doing old things in a new way.

Henry David Thoreau said, "The world is but a canvas to the imagination." Gift planners like artists, writers, and inventors have an opportunity to be creative. Not only can creativity serve our donors well, but it can also be fun.

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