UNDERSTANDING TAX ISSUES THAT CAN LEAD TO BIGGER GIFTS

PG CALC WEBINAR

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Introduction

When we scheduled this webinar six months ago, the world was a very different place. Even three months ago, the world was a very different place, although by then the novel coronavirus had begun to spread beyond China. As a consequence, some of what I expected to write about has shifted in the context of a global pandemic and abrupt changes in the financial markets and the economic outlook.

On February 18, 2020, the S&P 500 hit yet another record high, closing at 3370.29 that day. That peak was the culmination of an unprecedented eleven-year run without an economic recession. The Great Recession of 2008-2009 had become a dim, albeit unpleasant, memory. As the world knows all too well, the COVID-19 pandemic brought this winning streak to an abrupt and painful end. In a matter of weeks, thousands of businesses closed their doors, at least temporarily, millions of Americans filed for unemployment benefits, and most Americans began hunkering down at home. The S&P 500 plunged 33% over the next 34 days and other market indices suffered similar results. Interest rates approached 0%. Most economists believe a recession – two consecutive quarters of economic contraction - is unavoidable. It is now a question of how long and how deep.

Federal, state, and local governments have taken extraordinary steps to try to slow the spread of the novel coronavirus. In addition, the new CARES Act will provide an incredible $2.2 trillion to help the millions of individuals and businesses affected by the economic consequences of the pandemic.

Despite all this recent gloom, there are a variety of opportunities for donors to make gifts that are particularly attractive under current conditions. While many of your donors will not be comfortable considering a substantial gift during such unsettling times, some of them will be eager to learn how they can help your organization continue with its work. Gift planners are especially skilled at building relationships and therefore ideally positioned to identify donors who are ready to consider a planned gift in 2020. The goal of this paper is to offer some gift planning ideas that these donors may find appealing.

II. Opportunities for New Irrevocable Gifts

A. Qualified Charitable Distributions from an IRA

Qualified charitable distributions (QCDs) from an IRA have received attention from gift planners since they were first made possible in 2006 through 2007. After several years of lapsing and being extended, the QCD was made permanent in 2015 by the PATH Act. Since then, the promotion of QCDs has taken off and donors have responded in kind.

Most gift planners know the basics of how QCDs work, but it can’t hurt to list the rules here.

- The IRA owner must be age 70 ½ or older on the date of distribution.

- The gift must be made to a public charity, not to a private foundation, supporting organization, or donor advised fund.

- The donor must receive no benefit in exchange for the gift. No life income arrangements.

- The total of all QCDs made in a year cannot exceed $100,000 per taxpayer.

- The gift must be from a traditional IRA or Roth IRA, or from a SEP IRA or SIMPLE IRA that is not an ongoing plan. As a practical matter, almost all QCDs are made from traditional IRAs.

Ordinarily, the withdrawal of funds from an IRA or any other retirement plan is taxable as income because it has never been taxed before (Roth IRA withdrawals are an exception). The tax benefit to the donor of a QCD is that the donor does not report the funds removed from the IRA as income. The QCD also counts against the donor's required minimum distribution (RMD), the fraction of the IRA balance that IRA owners who are 72 or older must remove from their IRAs each year. The fraction increases as the IRA owner ages.

The QCD has become popular because it enables a donor to solve several tax issues while supporting one or more charitable causes the donor believes in.

1. Most donors do not itemize their deductions. With the near doubling of the standard deduction and limiting or elimination of many itemized deductions in the 2017 tax act, the proportion of U.S. taxpayers who itemize is now about 14%. A donor who does not itemize gets no benefit from a charitable deduction. The donor's tax benefit from making a QCD does not require itemizing a deduction.
2. With the SECURE Act passed at the end of December 2019, retirement plan owners must start taking RMDs in the year they turn age 72. For charitably-minded donors who don't need their RMD for their own use, fulfilling their RMD by making a QCD is a tax-efficient way to make a charitable gift: they avoid paying tax on the required withdrawal, whether they itemize or not. The CARES Act, passed in late March 2020, suspends RMDs from most defined contribution plans, including IRAs, for 2020. Fulfilling the RMD will return in 2021 as an incentive for making QCDs.
3. A withdrawal from an IRA increases the taxpayer's adjusted gross income (AGI). For some taxpayers, increasing AGI may increase their Medicare Parts B and D payments, the 3.8% tax on net investment income, and other costs, even if the withdrawal is offset by an itemized deduction. The QCD avoids this possibility.

The charitable IRA rollover is beneficial to donors who:

- Do not itemize their charitable deductions. More of these donors will live in the nine states that do not have a state income tax.

- Regularly contribute up to the applicable AGI limits on their itemized deductions. This will be less of an incentive in 2020 because of a change in the CARES Act that effectively raises the limit on cash gifts to 100% of AGI (see item B below).

- Want to reduce their Medicare premiums. This is because the minimum required distribution is included in the donor's income used to determine their Medicare Part B and Part D premium costs. For example, a married couple with income of $174,001 in 2020 will owe an additional $694 in Medicare premiums than if their income were $174,000. If their income is just $1 over $170,000, they will have to pay the full extra premium. For a married couple with income of $326,001 in 2020 the premium increase is $1,040 a year in 2020. The reduced taxable income from a charitable IRA rollover could save some donors significant amounts.

- Live in a state with a state income tax that does not permit charitable deductions, such as Massachusetts.

- Like the simplicity of transferring money from an IRA rather than the two-step process of taking a taxable withdrawal and then contributing it to charity.

B. Leveraging the Temporary 100% Limit on Deductions for Gifts of Cash

One of the provisions in the CARES Act allows donors to elect a new 100% of adjusted gross income (AGI) limit for cash gifts made in 2020 to public charities ("50% charities"). Gifts to donor advised funds (DAFs) or supporting organizations (SOs) are not eligible for this special election. The 100% limit is reduced dollar-for-dollar by other itemized charitable deductions. This means that in 2020, a donor who deducts 30% of her AGI in long term appreciated property gifts and elects the 100% of AGI limit for qualified cash contributions will be able to also deduct up to 70% of her AGI for qualified cash gifts, a total deduction of up to 100% of AGI. Ordinarily, this donor's total deduction would be limited to 60% of AGI and she would have to carry forward the rest. A donor who makes the 100% of AGI election can carry forward unused qualified cash gift deductions up to 5 years. The carryforward will be subject to the normal 60% of AGI limit, as are cash deductions carried forward from past years.

The temporary availability of a 100% of AGI limit on gifts of cash presents a big opportunity for donors to make large gifts from their retirement plans. This includes not only IRAs, but also 401(k)s, 403(b)s, and other defined contribution plans. Ordinarily, donors are advised against withdrawing funds from their retirement account and then giving them to charity because they must declare the withdrawal as income and limits on taking an offsetting deduction and other tax effects may result in their gift increasing their gift.

Imagine Joanne, who has $1 million accumulated in her IRA. She has been using her IRA funds to make charitable gifts but has been limiting herself to making QCDs equal to her RMD each year. Last year that was a little over $43,000. She is a major donor to your organization and would like to make a $250,000 gift to its capital campaign. Her advisor reminds her that the maximum she can give using a QCD is $100,000. The advisor notes, however, that she could withdraw $250,000 from her IRA, then give the $250,000 in cash to your organization. She would have to declare the $250,000 withdrawal as income but could make the 100% election and deduct the entire $250,000 from her taxes. She has enough other income that even if she makes other gifts using appreciated stock, she will have ample adjusted gross income to use all $250,000 of deduction and her advisor has determined that the additional $250,000 in adjusted gross income won't otherwise affect her taxes or costs. The result is that she will pay no net tax on her withdrawal, she will make the gift she wants to make, and she will expedite the use of her IRA to make charitable gifts.

Unlike with the QCD, this strategy is open to donors with other types of defined contribution plans. As long as the donor is over 59½ and therefore not subject to the 10% penalty tax on early withdrawals, taking advantage of the 100% election presents an opportunity to make large charitable gifts from retirement assets in 2020.

The 100% election may also be an opportunity for a donor to give valuable collectibles, such as artwork, antiques, or rare coins, to charity. If the donor were to give the property itself to charity, the donor's deduction would be limited to his cost basis in the property unless the charity kept the property and put it to a use related to its mission. Also, his deduction would be limited to 30% of his adjusted gross income. If the charity intends to sell the donated property and use the proceeds, the donor likely will be better off selling the property himself, realizing the capital gain, then giving the cash proceeds from the sale to the charity and taking the resulting deduction. With the availability of the 100% election in 2020 for cash gifts, the donor will be able to more than offset the reportable gain from the sale by itemizing the deduction for the gift.

Imagine Mr. Jackson, age 78, owns a valuable painting worth $500,000 that he inherited several decades ago when it was worth $200,000. Assuming the charity will not put the painting to a related use, here's how his tax benefits will work out if he gives the painting outright to a charity versus selling the painting himself and giving the proceeds.

	Give Painting	Sell Painting, Give Proceeds
Painting FMV	$500,000	$500,000
Painting cost basis	$200,000	$200,000
Realized gain	$0	$300,000
Capital gain tax (@ 28%)	$0	$84,000
Charitable deduction	$200,000	$500,000
Income tax savings (@ 35%)	$70,000	$175,000
Capital gain tax	- $0	- $84,000
Net tax savings	$70,000	$91,000

Mr. Jackson will save $21,000 more in income tax by selling the painting and giving the proceeds than by giving the painting itself. If the charity plans to put the painting to a related use, however, the conventional advice to give the painting itself to the charity will likely provide the most tax benefit to Mr. Jackson. In this case, he would be able to take the entire $500,000 fair market value of the painting as a deduction, which will save him $175,000 in income tax, assuming he is able to use the entire deduction in the year of the gift plus five additional tax years. He won't owe any capital gain tax, either.

If Mr. Jackson is interested in using the value of his painting to create a life income stream for himself, he could fund a flip charitable remainder unitrust with his painting. The trust would act as a net income unitrust until the painting is sold and then flip to a standard unitrust. This way, the trustee would not have to make income payments while the trust holds the painting and has no income but would be able to pay the stated unitrust percentage each year after the painting is sold. Despite his deduction being based on his cost basis in the painting, unless the deduction percentage for funding the unitrust is very high, giving the painting to the unitrust will provide a larger tax benefit to Mr. Jackson than selling the painting and giving the proceeds (see columns below). Worth noting, if he funds the unitrust with the painting, he won't be able to take a deduction for his gift until the year in which the unitrust sells the painting.

	Give Painting	Sell Painting, Give Proceeds
Painting FMV	$500,000	$500,000
Painting cost basis	$200,000	$200,000
Realized gain	$0	$300,000
Capital gain tax	$0	$84,000
Charitable deduction (64.7%)	$129,496	$323,540
Income tax savings (@ 35%)	$45,324	$113,239
Capital gain tax	- $0	$84,000
Net income tax savings	$45,324	$29,239

The 100% election may not always be the tax-wise choice: Because federal income tax rates are progressive, it is not a given that it will be to a donor's advantage to make the 100% of AGI election. For example, a single donor who has taxable income of $200,000 is in the 32% federal income tax bracket. If the donor makes $200,000 in qualified cash contributions, makes the 100% of AGI election, and itemizes no other deductions, he will pay no federal income tax in 2020, saving $45,015.50 in tax as a result. However, if he doesn't make the election, he would deduct $120,000 and carry forward $80,000 to 2021. Assuming he can deduct the remaining $80,000 in 2021 and again has taxable income of $200,000, he will save $31,625 in federal income tax in 2020 and approximately another $22,136 in 2021, a total tax savings over the two years of $53,761. A donor in the highest federal tax bracket, 37%, could see an even larger tax benefit by not taking the 100% election. Donors, such as Joanne and Mr. Jackson in the examples above, should consult their tax advisers to determine whether the 100% election will make sense for them.

C. Obtaining Double Leverage by Funding a Charitable Lead Annuity Trust with Depressed Securities When Interest Rates Are Low

A charitable lead trust is the reverse of a charitable remainder trust. Instead of paying income to one or more individuals and then distributing the remainder to one or more charities, it pays income to one or more charities, and then distributes the remainder to one or more individuals. Lead trusts usually last for a term of years, but they can last for the lifetime of an individual who meets the qualification of a related person. A lead trust can be established during the lifetime of a donor, or at the donor's death through a will or living trust. The payment to charity must be a fixed dollar amount ("charitable lead annuity trust") or a fixed percentage of trust assets as determined annually ("charitable lead unitrust").

The non-grantor charitable lead trust is the most common form. The grantor (or "donor") is not treated as the owner of the trust assets. At the termination of the trust, the remaining principle is distributed to others (typically family members), and the donor retains no personal financial interest in the trust. The present value of the payments that will go to charity qualifies for a gift or estate tax charitable deduction, depending on whether the trust is funded during the donor's life (*inter vivos*) or at death (testamentary).

A non-grantor lead trust is a taxable trust. It pays income tax on its net income, including realized capital gain, according to the income tax schedule for estates and trusts. However, it gets a charitable income tax deduction each year for its payments to charity that year. The charitable deduction is unlimited, so a lead trust whose charitable payments during the year equal or exceed its net income will not pay income tax. There is no carryforward if the deduction exceeds the trust's net income for the year, so a lead trust will pay income tax in any year in which it has net income greater than its charitable payout.

Charitable lead annuity trusts (CLAT) are very appealing to donors with estates large enough to owe federal estate taxes when interest rates are low because the charitable deduction for funding the CLAT is high. The following chart compares over a range of IRS discount rates the charitable deduction for a $1,000,000 CLAT with a 15-year term that pays $70,000/year to charity. Payments are annual at the end of the year. Note that 0.8% is the rate for May 2020.

IRS Discount Rate	Amount of Contribution Deductible
0.6%	1,000,000 *
0.8%	$985,740
1.0%	970,550
2.0%	899,450
3.0%	835,660
4.0%	778,290
5.0%	726,580

* A payout of $69,911 would be sufficient to earn a $1,000,000 deduction.

With the non-grantor charitable lead trust, the gift or estate tax charitable deduction is leveraged. If the AFR reaches 0.6%, none of the $11.58 million gift tax exemption would need to be used when funding a 15-year 7% CLAT. In other words, a wealthy donor could transfer *any* amount to this lead trust and the taxable gift would be $0. What's more, the amounts in the lead trust would be out of the donor's estate and therefore never exposed to estate tax. Even if the IRS discount rate were 1.0% rather than 0.6%, a transfer of $1 million to this trust would use only $29,550 of the donor's gift tax exemption. In theory, the donor could transfer over $390 million to the lead trust without paying any gift tax. Whatever remains in the lead trust when it terminates would be free of estate tax, including any growth in the value of these assets while in the lead trust.

The donor can leverage the tax benefits of a lead trust even more right now by contributing stock that has lost significant value recently, but which the donor expects to bounce back once the pandemic is brought under control. Consider the following example:

Richard and Jeanne would like to transfer approximately $5 million to each of their two daughters when they are older, and in the meantime, they want to provide substantial support to two favorite charities. They transfer stock to a charitable lead annuity trust with a seven-percent payout rate and a term of 15 years. Assume the IRS discount rate is 0.8%. The stock, which at the beginning of the year was worth $10,000,000, is now worth "only" $7,000,000. Richard and Jeanne report a taxable gift of just $142,600, which they offset with an equal amount of their gift tax exemptions and therefore pay no gift tax. During the next three years the stock recovers its value and then maintains its value for the balance of the trust term, so that $10,000,000 remains in the trust when it terminates. Richard and Jeanne will have achieved a nearly 70:1 leverage of their gift tax exemptions. For a taxable gift of only $142,600, they pass $10,000,000 to their daughters, and they make charitable gifts totaling $10,500,000 over the CLAT's 15 year term, half to each of the two charities. If they were to make the term of their lead trust 20 years, rather than 15, they could earn a 100% charitable deduction by setting the payout rate at a little over 5.4%. This would increase the likelihood that the trust assets would increase in value over the term of the trust, all to the benefit of their daughters while avoiding gift and estate tax entirely.

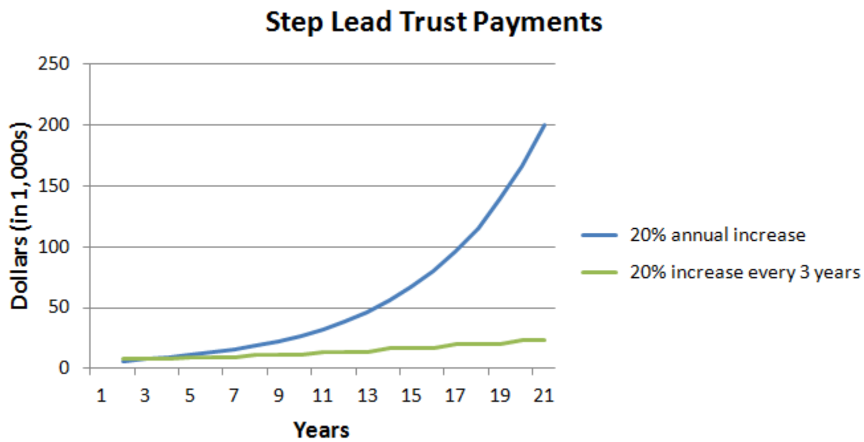
Note that a lead trust is a taxable trust and inherits the cost basis of the donor. The lead trust pays income tax on income in excess of its payments to charity during the year. If Richard and Jeanne's cost basis in the stock used to fund the lead trust is low, the trustee can minimize the taxes paid by the trust by holding the stock or by selling it incrementally so that the capital gain realized each year is largely or completely offset by the payments to charity.

The daughters will inherit the trust's cost basis when the trust terminates; they do not get a step-up in basis. Since the top gift and estate tax rate, 40%, is considerably higher than the top capital gains tax rate, 20%, it is usually better to shelter appreciation from gift or estate tax and have it taxed as capital gain rather than the other way around.

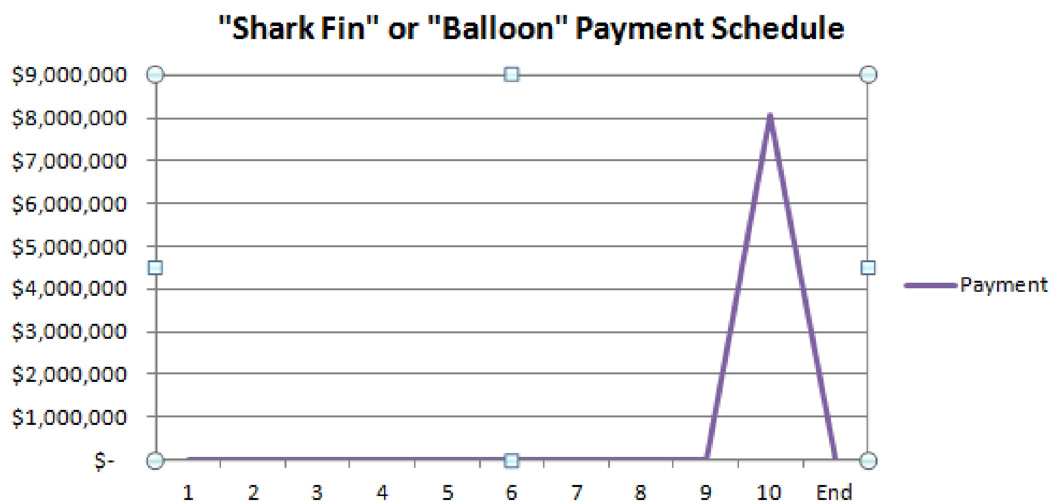
D. Using a Step Lead Annuity Trust with a Closely-Held Business Interest

A non-grantor lead annuity trust has enough flexibility to be a solution for a donor who wishes to pass on the value of a closely-held business to children or others. There are complications to funding a non-grantor lead trust with this sort of asset, but they can be overcome in some cases, resulting in a very beneficial gift for the charity and a tax-efficient transfer of value to the donor's heirs.

1. The business may not generate enough income to make the payments to charity each year. This concern can be addressed by constructing a schedule of lead trust payments that begin low and increase over time, for example 20%/year, giving the trust time to accumulate liquid assets during the early years that can be used to make payments in later years. This is the step lead trust (see Revenue Procedure 2007-45 and PLR 201216045 for legal authority). The graph below shows that setting the increase at 20%/year heavily weights payments into the later years.



2. An extreme form of the step lead annuity trust is the "shark fin" or "balloon" lead trust: rather than increase its payments at a steady clip over the course of its term, a shark fin lead trust makes small payments every year of its term except the last, and then makes a very large payment in its final year. If you graph this payment pattern – and use your imagination – the final payment looks something like a shark's dorsal fin slicing through the water, as demonstrated in the graph below.



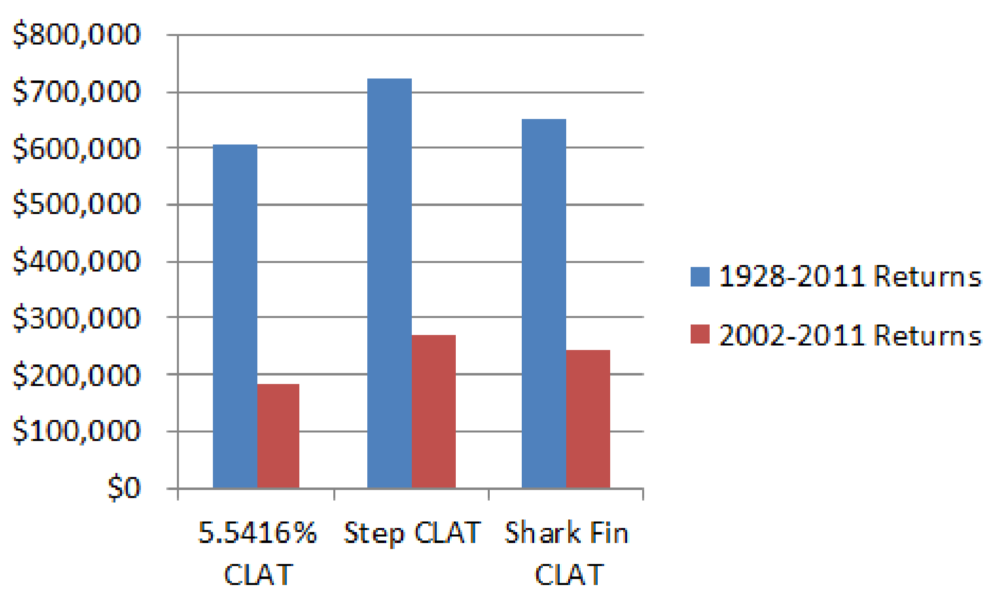
3. If the present value of the lead interest is greater than 60% of the funding amount, the rules against excess business holdings and jeopardy investments will apply. Such a CLT and its disqualified persons are not allowed to own, in total, more than 20% of the assets of the business. (Disqualified persons include the donor, the donor's family, the trustees of the CLT, and entities in which any of these people own 35% or more of the voting power, profits, or beneficial interest). When the excess business holdings prohibition applies, the CLT has 5 years to reduce these holdings to no more than 2%. Therefore, if the donor expects the business to be sold within a few years of creating the CLT, excess business holdings may not be of great concern.

If the donor's goal is to pass stock in a closely-held business to her heirs, and she expects the stock's value and dividends to grow over time, a step lead annuity trust could work very well, with payments to charity growing as dividends grow, thereby minimizing the income tax paid by the trust. Alternatively, if the donor anticipates a sale of the business, she could create a shark fin trust and plan to sell the business in the year of the balloon payment (she will need to be wary of the prohibition against self-dealing here). In both these situations, it can be wise to fund the lead trust with liquid assets in addition to the closely-held stock so that there are funds available to make the payments to charity in the event dividends from the closely-held stock are not sufficient.

The step lead trust is also attractive to donors with large holdings of publicly traded stock when the market is volatile, which is certainly the situation today. Making the payments of the trust lower in its early years (step lead trust) or very low until its final year (shark fin lead trust) reduces the effects of poor investment results in the early years, should they occur. Even if investment results are good in the early years, the step lead trust and shark fin lead trust ordinarily will accumulate more assets for the benefit of the trust's heirs than a standard CLAT.

This likely enhanced benefit to heirs of a step or shark fin lead trust over a standard lead trust is borne out in a Monte Carlo analysis of the three types. The graph below shows the results if the investment return of three $1 million lead trusts, each lasting 20 years and earning a 100% gift tax deduction, but differing in their schedule of payments: one paid $55,416 each year, one increased its payments 20%/year, and one paid $1,000/year until the last year when it made a balloon payment of nearly $1.2 million. At every confidence interval – 25%, 50%, 75%, and 90% (shown below) - the Monte Carlo simulation predicted the step annuity and shark fin trusts would transfer more to heirs than the standard trust.

Monte Carlo Simulation: 90% Confidence Interval for Principal at End of Term



E. Using a Grantor Charitable Lead Trust to Make a Capital Campaign Gift

A charitable lead trust is a "grantor" trust if the grantor (or "donor") is treated as owner of the trust. The grantor is treated as the owner if she retains a reversionary interest in the trust with an actuarial value of more than five percent of the trust value at the time the trust is established. In almost all cases where the trust principal will be returned to the grantor, the grantor will be treated as the owner.

The grantor is entitled to an income tax charitable deduction for the present value of the income interest. The donor is taxed on all trust income and realized gain as if the trust did not exist. No deduction is allowed each year for payments to charity.

As with a non-grantor CLAT, a very low IRS discount rate allows a grantor CLAT to earn an unusually generous charitable deduction, this time against income tax rather than gift tax. As a result, right now a grantor CLAT can be a great way to make a large capital campaign gift. Consider, for example, the case of George, who has been asked for a $500,000 campaign gift. His alternatives are:

- Contribute $500,000 now in a lump sum (ideal from the charity's standpoint, for it has the use of all the money from day one).
- Make pledge payments of $100,000 per year for the next five years. (The charity bears the risk of an unfulfilled pledge.)
- Establish a grantor charitable lead annuity trust that pays the charity $100,000 per year for five years. (Though payments are spread out over five years, the charity can be sure to receive them.)

Here are possible consequences of the grantor lead trust:

Amount contributed to the trust in May 2020	$500,000
Income tax charitable deduction (0.8% AFR)	488,220
Income tax savings (37% tax rate)	180,641
Income tax paid during term by donor	22,765
Amount returned to donor after five years[1]	126,202
Net cost of $500,000 campaign gift ($500,000 – 180,641 + 22,765 – 126,202)	$215,922

[1] Assumes an investment return on trust assets of 2% income and 5% appreciation.

The donor's net cost of giving $500,000 over 5 years is just $215,922. Were the donor to invest the $500,000 himself and make contributions each year of $100,000 for five years, his income tax savings would be similar, assuming he can use his entire deduction in both cases and his tax bracket remains the same over the five years, but he would have only $85,947 left after making the last $100,000 pledge payment, over $40,000 less than the grantor lead trust would return to him.

Note that the charitable deduction for an appreciated property gift to a grantor lead trust is limited to 20% of the donor's AGI because it is considered a gift "for the use of" the charity rather than "to" the charity. Any unused deduction can be carried forward for up to 5 years.

When the IRS discount rate is well below expected investment earnings and the donor can make use of a large income tax charitable deduction, a grantor lead annuity trust can be very appealing.

F. Reducing Income Tax with a Gift of a Remainder Interest in a Personal Residence

For many donors, their home is one of their most valuable assets, if not the most valuable. Unless prompted, most are unlikely to consider giving their home to charity. It's where they live! Nevertheless, right now is an especially opportune time for a donor to do just that.

A donor may transfer title to a personal residence or farm and retain the right to live in the property for life. This arrangement is known as a retained life estate. The donor receives an income tax deduction for the present value of the charity's remainder interest. The size of this deduction depends on the IRS discount rate in effect at the time of the gift and, like a charitable lead annuity trust, a lower IRS discount rate results in a larger deduction. Since the current IRS discount rate is at a historical low, the deduction from such gifts will be larger than ever before and continue that way for as long as the IRS discount rate remains so low.

Consider Nancy, who is single and age 74. She purchased her home many years ago, and it has recently been appraised for $500,000. The land is worth $200,000 and the house $300,000. The appraiser considers the house to have a useful life of 45 years and a salvage value of $75,000. Nancy would like to continue living in her home for the duration of her life and assure that it then goes to charity. She would also like to reduce her taxes now. In May, she gives the property subject to a retained life estate and receives a charitable deduction of $427,292.

The chart below shows how her deduction would vary with different IRS discount rates.

IRS discount rate	Charitable Deduction
0.8%	404,365
1.0%	395,815
2.0%	356,852
3.0%	323,384
4.0%	294,485

If she decides to move because of failing health or some other reason, she can:

- Rent the property and be entitled to the income.
- By agreement with the charity, sell the property and divide the proceeds according to the respective values of their interests in the property.
- Contribute her life interest and receive another charitable deduction.
- Contribute her life interest in exchange for a gift annuity.

G. Combining a Retained Life Estate with a Gift Annuity

As their income from their investments has fallen, some senior citizens are interested in converting some of the equity in their home to payments. One possibility is a reverse mortgage that can be arranged with a bank. Another is a gift of the remainder interest in a personal residence for a gift annuity.

Suppose a charity were willing to pay Nancy an annual annuity of $15,000 in exchange for a gift of the remainder interest in her home. She would be able to supplement her income from other sources without altering her lifestyle. The charity will probably have to use other assets to meet state reserve requirements, and it will have to use general funds to make annuity payments unless it has significant surplus reserves that can be tapped. Nevertheless, if the donor is in the right age range and the charity is conservative in the gift annuity rate it pays ($15,000 is about 20% less than the ACGA suggested maximum rate), this transaction can be profitable for the charity, as well as the donor. If Nancy were to live to age 92 (her life expectancy according to the 2012 IAR mortality table), the charity would have paid $255,000 in annuity payments plus the return it would otherwise have earned on the money used for the payments. Still, it will have received a property worth $500,000 even if the property does not appreciate in value.

There are many persons who, in the current environment, would be interested in a plan whereby they can still live in their home, receive extra cash, and make a future gift. Whether a charity should promote such plans depends on its available resources and its risk tolerance.

H. Bargain Sale of Real Estate

Sometimes a charity is eager for additional space. For example, a school may be interested in acquiring lots that are adjacent to its existing campus. A donor who owns a home that the school wants to acquire for its own use could enter into a retained life estate agreement with the school. As already noted, the extremely low IRS discount rate makes this a particularly opportune time for retained life estates. However, the charity may not want to wait for years before it can use the property to further its mission.

Another option for the donor is to sell the property to the school at a bargain price. A bargain sale would enable the charity to acquire and use the property immediately for a cost well below fair market value.

The sale price is negotiated between the donor and the school. The donor gets a charitable deduction for the difference between the fair market value of the property and the sale price. If the property is appreciated, the donor must report the capital gain attributable to the sale portion of the transaction. If there is outstanding debt on the property, the debt is added to the sale price for tax purposes.

From the donor's standpoint, selling the home at a bargain price will enable her to reduce or eliminate capital gains tax she would otherwise owe on the sale, benefit from an income tax deduction, raise cash for other expenditures she has planned, and unload the responsibility and costs associated with owning the property.

Suppose Nancy purchased her house that is now worth $500,000 for $100,000. She owns her home free and clear and she is ready to downsize. The college across the street is interested in acquiring her home. She is in the 24% federal income tax bracket, so she would pay 15% tax on $150,000 of capital gain if she were to sell the house herself ($400,000 - $250,000 exclusion on the sale of her primary residence). Instead, she could sell her house to the college for $250,000 with the following results:

Proceeds from sale paid to Nancy:	$250,000
Charitable deduction:	$250,000
Reportable gain:	$200,000
Taxable gain ($200,000 - $250,000 exclusion on sale of primary residence):	$0

Nancy still makes a handsome profit on the sale of her house, receives a substantial income tax deduction, and is able to reduce her reportable capital gain enough that she can avoid paying any capital gain tax by applying her $250,000 capital gain exclusion on the sale of a primary residence. At the same time, she has the satisfaction of making a generous gift to the college that it can use immediately, and the college is able to acquire property it wants for half its fair market value.

Any type of property can be used in a bargain sale, not just real estate. Most often, the sale is completed with a single payment of the sale price, but it is also possible for the payments to be made in installments. In this case, the payments typically are partly interest income, partly capital gain, and partly tax-free, much like gift annuity payments. (A gift annuity is, in fact, a form of bargain sale.)

I. Donate S Corporation Stock or Assets

A Subchapter S corporation is a popular form of business organization that provides the legal protections of incorporation to the shareholders of the business while being taxed as a partnership. Net income flows to the tax returns of the shareholders, thereby being taxed just once, at the individual level, rather than twice, once at the corporate level (net income) and once at the individual level (dividends). S corporations must be domestic and cannot have more than 100 shareholders, so they tend to be small compared to publicly traded companies. Nevertheless, many are worth many millions of dollars. According to IRS statistics, at the end of 2014 there were over 4 million S corporations in the U.S. with total assets of nearly $4 trillion and net income of about $500 billion.

There are two options for a donor who wishes to give charity value in an S corporation. One is to give shares of stock in the S corporation. The other is to give assets of the S corporation.

Gift of S corporation stock
A donor can give shares in an S corporation to a charity without jeopardizing the S corporation status of the business. The shares most likely would be highly appreciated, in which case the donor would be able to take a charitable deduction for the fair market value of

the shares up to 30% of the donor's adjusted gross income (AGI). The donor would be able to carry forward unused deduction for up to five years.

The charity would likely want to sell the S corporation shares quickly. All net income allocable to the S shares it holds, including passive income the S corporation earns (such as from interest and dividends on its own investments), would be taxable to the charity as unrelated business taxable income, whereas the charity generally is not taxable on its other investments. Depending on how the charity is organized, this income would be taxable at either corporate rates or trust rates. This may be an acceptable burden if the charity is confident it will be able to sell the S corporation shares quickly – for example, because several investors have recently expressed interest in acquiring the business.

Since a gift annuity is a form of bargain sale, a charity can accept shares in an S corporation in exchange for a gift annuity without jeopardizing the S corporation status of the business. A donor whose major asset consists of stock in a family business organized as an S corporation, could give shares in the business in exchange for a gift annuity. This gift plan would allow the donor to make a generous gift to charity while preserving the cash flow he is used to from the business. Even more so than with an outright gift of S corporation stock, the charity would want to be confident that it will be able to sell the shares quickly, since it will be on the hook to make the annuity payments as well as to pay tax on its share of the S corporation's net income.

A charitable remainder trust cannot own shares in an S corporation. Doing so destroys the S corporation status of the business, which could have unwelcome tax consequences for all the shareholders. Unless all the shareholders are agreeable to losing S corporation status, funding a charitable remainder trust with S corporation stock is not an option.

Gift of S corporation assets
Rather than give S corporation shares, a donor can arrange for the S corporation to give assets of the corporation instead. In this case, the deduction for the gift flows through to the shareholders according to their ownership share of the S corporation and subject to the usual AGI limitations on each shareholder's tax return: 60% (cash), 50% (non-cash, except long term appreciated property), and 30% (long term appreciated property).

Prior to 2006, when an S Corporation gave assets to charity, the cost basis of each shareholder's shares in the S Corporation was reduced by each shareholder's share of the *fair market value* of the donated assets. This was fine when the S corporation gave cash, but not so fine when the S corporation gave long term appreciated property. Starting in 2006, when an S Corporation gives assets to charity, the cost basis of each shareholder's shares in the S Corporation is reduced by each shareholder's share of the S corporation's *cost basis* in the donated assets.

The benefit of this change can be demonstrated by an example involving Norman and his brother, Glen. Each owns 50 percent of the stock in an S corporation. The basis of each brother's stock is $120,000. The corporation contributes to a charity a parcel of real estate that has an appraised fair market value of $200,000 and an adjusted cost basis of $40,000. Each brother is treated as having made a charitable contribution of $100,000, and each brother's basis in his S stock will be reduced by $20,000 (one-half of the corporation's basis in the real estate). Thus, following the transaction, the new basis of each brother's S stock is $100,000. Under the rules prior to 2006, each brother would have had to reduce the basis of his S stock by $100,000 (one-half of the fair market value of the real estate). After the gift, the basis of each brother's stock would have been a mere $20,000, and they likely would not have caused their corporation to make the gift.

The current more favorable adjustment of shareholder cost basis when an S corporation gives assets to charity makes funding a CRT with S corporation stock a more viable option. Doing so also avoids termination of the corporation's S status that giving S corporation stock itself would force. Taking the example of Norman and Glen again, suppose they want to support your charity and also provide income to their 85-year-old mother. They could have their S corporation give the real estate to a 5% flip charitable remainder unitrust with their mom as income beneficiary and make the sale of the real estate the triggering event for flipping the unitrust from a net income unitrust to a standard unitrust. This plan would avoid immediate recognition of the corporation's considerable gain in the real estate, create a lifetime income stream for their mom (starting at $10,000/year), and provide a generous gift to your charity.

Two caveats with this plan.

1. All shareholders of the S corporation need to be agreeable to making the gift. The gift cannot be allocated to just one shareholder.
2. If the S corporation gives substantially all of its assets to fund the unitrust, it will recognize gain on the transfer under Code Section 337(d).

III. Opportunities for Revocable Future Gifts

A. Name a Charity as Beneficiary of All or a Portion of an IRA or other Retirement Plan

A donor can name a charity as beneficiary of all or a portion of an IRA or other retirement plan. It could be 10 percent, 25 percent, 50 percent, or even the entire amount if there are no heirs. Following death, that portion of left-over retirement funds would be paid to the charity in a lump sum, totally tax-free. The balance could be paid to other beneficiaries according to whatever schedule they elect, and the charitable gift will not affect that distribution schedule. If family circumstances change, the donor can alter the percentages by completing a new beneficiary designation form.

Example: Alvin, a widower, rolled his late wife's IRA into his own. He would like to leave a charity approximately $500,000, with the balance of his estate going to his two children. His total estate is approximately $6,000,000 and consists of the $500,000 in his IRA, appreciated securities worth $4,000,000, cash investments of $500,000, and a home and personal property worth $1,000,000. What asset should be used for his charitable gift?

Option 1 – Give $500,000 from his general estate assets to charity and the IRA to his children.

Estate tax savings		$0 *
Income tax savings	+	$0
Total tax savings		$0
Net cost of gift		$500,000

Option 2 – Give the IRA to the charity and other assets to his children.

Estate tax savings		$0 *
Estimated income tax savings		
(Assuming 35% combined tax rate)	+	$175,000
Total tax savings		$175,000
Net cost of gift		$325,000

* The federal estate tax exemption is $11.58 million in 2020. Absent action by Congress, the current exemption, which is indexed for inflation, will expire at the end of 2025 and will be roughly half as much thereafter.

General rule: Upon death, it is better to make charitable gifts with IRAs and qualified retirement funds (or with other "income in respect of a decedent" ("IRD"), such as savings bonds and commercial annuity contracts) and give cash, securities, and real estate to heirs. This is true even for donors whose estates are not large enough to be subject to federal estate tax because the benefit is in avoiding income tax on the retirement funds.

Caution: The donor must make the charity a direct beneficiary of the retirement fund. If the estate is the beneficiary, and the will provides for a certain sum to be paid to the charity, the distribution will be taxed on the decedent's final income tax return, and there will be no offsetting deduction unless the will specifically states that charitable bequests shall be made, to the extent possible, with the retirement funds or with IRD assets, which includes taxable retirement plan distributions.

B. Establish a Charitable Remainder Trust for Survivors with Remaining Retirement Fund Assets

Prior to the SECURE Act, which went into effect on January 1, 2020, the inheritor of an IRA could "stretch" out her required withdrawals of IRA assets over her life expectancy, which could be many decades when the inheritor was the deceased's child or anyone else much younger than the deceased. For example, a 50 year-old could stretch her required withdrawals over 34 years. As long as the funds remained in the IRA, they could continue to grow tax-free. For most IRAs inherited by a non-spouse, the SECURE Act requires the assets to be distributed within 10 years, significantly reducing the ability to shelter assets in an inherited IRA from tax. Here are the new rules:

- A non-spouse beneficiary more than 10 years younger than the deceased owner must empty the IRA within 10 years.
- There are no required minimum distributions during the 10 years.

- Exceptions to the 10-year rule, in addition to spouses and beneficiaries less than 10 years younger than the deceased owner: minors (until they reach majority), the disabled, and the chronically ill.

Much has been written since the SECURE Act went into effect about the appeal of a testamentary charitable remainder trust as a replacement for the now defunct stretch IRA. This plan could work very well for a donor who wants a charity to be the ultimate beneficiary of her remaining retirement funds, but in the meantime wants to provide for children or other younger heirs. She could accomplish both goals by making a charitable remainder trust the beneficiary of her retirement plan. The trust could make payments to surviving children for life, much like the old stretch IRA. An important difference is that the surviving children will receive the benefit of the CRT payments only. With the stretch IRA, the children benefitted from all of the assets in the IRA. In situations where the parent wanted to control access to the stretch IRA funds by the children, a conduit trust or accumulation trust could be created so that a trustee could oversee and regulate distributions to the children. Nevertheless, all the assets in the stretch IRA were for the benefit of the family.

A major benefit of designating a CRT as the beneficiary of retirement plan assets is, like when assets are rolled over into an inherited IRA, no income tax will be payable on the retirement fund assets when they are paid to the CRT because the trust is tax-exempt. (Multiple PLRs support this conclusion. See PLRs 199901023, 9237020, 9253038, 9723038, 9634019.) Unless the distribution that establishes the trust comes from a Roth IRA or designated Roth 401(k) or 403(b) account, payments to the income beneficiary will be taxable entirely as ordinary income until total payments exceed the funding amount. Of course, payments would also have been fully taxable had the donor made the individuals the beneficiaries of the retirement plan.

The value of the heir's income interest will be subject to estate tax. Whether tax is owed will depend on the size of the donor's estate and the amount of the donor's other taxable gifts. These days, only 0.1% of estates are big enough to owe federal estate tax.

It is important to make the trust the beneficiary of the retirement plan rather than to name the estate as beneficiary and provide in the will for the creation of a testamentary charitable remainder trust. Otherwise, the retirement plan assets will be exposed to income tax. In order to make the trust the beneficiary of the retirement plan, the trust could be a charitable remainder trust established during the life of the donor and minimally funded; it could begin as a living trust that automatically converts to a charitable remainder trust at the death of the trustor; it could be unfunded until the death of the donor if this procedure is acceptable in the jurisdiction where the trust is sited; or the will might provide for its creation at the moment of death. The donor's advisors can recommend the best procedure whereby the trust can be named as beneficiary.

Example: John creates a charitable remainder unitrust and names it as beneficiary of 50 percent of his IRA. The trust will pay to his twin sons, age 55, six percent of trust assets, as revalued annually, for their lifetimes. Then the trust will terminate, and the remainder will be distributed to a charity. Following John's death, approximately $500,000 from his IRA will be paid to the trust, and his sons will split about $30,000 the first full year of the trust, an amount that will increase over the years if the trust assets grow in value. When the IRA funds are distributed to the trust, they won't be subject to estate tax or income tax. The trust payments will be taxed as ordinary income to his sons. The arrangement enables John to provide for his sons for their lifetimes after he is gone and gives him the satisfaction of assuring a future gift to a charity.

The table below compares funding the 6% CRUT for the sons to the same assets being rolled over by the sons into an IRA that they then empty over 10 years and from which they spend the same amount they are projected to receive, after taxes, from the CRUT.

	Charitable Unitrust 6%	**Inherited IRA**
Gross Principal	$500,000	$500,000
Charitable Deduction	$82,390	$0
Income	3%	3%
Capital Appreciation	5%	5%
After 39 years (life exp. of two 55 year-old males):		
Total After-Tax Benefit To Payment Recipients (spent)	$1,210,338	$1,210,338
Remaining Principal	$1,082,372 (to charity)	$4,448 (to heirs)
Total Benefit	$2,292,710	$1,214,786

If the sons live to their joint-life expectancy, between them they will have just $4,448 more by inheriting the IRA than they would by receiving payments from the CRUT, a tiny price for them to pay so that their father can pass over $1 million to charity via the CRUT.

These results depend on several factors, including the payout rate of the CRUT, investment performance, the son's marginal tax rate, and how long the sons live. For example, if the sons live 34 years rather than 39, they would have nearly $200,000 left from their inherited IRA to pass to heirs.

If the donor wants to assure the charity will receive the remainder within a reasonable period, a term for the shorter of the sons' lives and a fixed term of 20 years could be used instead. This approach would assure that the trust lasts no longer than 20 years. Of course, shortening the term will reduce the trust's benefit to the sons.

Issues Regarding Funding the Trust: Under Reg. Sec. 1.664-1(a)(5), a testamentary charitable remainder trust is deemed created at the death of the donor. However, the actual distributions for funding the trust are made following death, and there may, in fact, be several distributions occurring over weeks, months, or even several years before the trust is fully funded.

Reg. Sec. 1.664-2(b) provides that all property passing to the trust by reason of the death of the donor shall be considered as one contribution. The payment to the income beneficiary would be the total amount distributed to the trust multiplied by the payout percentage calculated as if the full amount had been received on the date of death. Treasury Regulations 1.664-1(a)(5)(i) and 1.664-1(a)(5)(ii) provide detailed instructions on how to calculate the amount by which a testamentary charitable remainder trust has underpaid or overpaid its income beneficiaries during the period between the donor's death and the full funding of the trust, if permitted by applicable local law or authorized by the governing instrument.

IV. Conclusion

There are many options for donors to make meaningful gifts to charity. Cash and publicly traded securities can make wonderful gifts, but so can gifts of other valuable assets that many donors possess, such as real estate, collectibles, closely-held stock, and retirement assets. We have reviewed some of the ways donors can give these assets to benefit themselves and their favorite charities. Recent changes in tax law and the current extremely low IRS discount rate have created some unusual gift opportunities for donors, as well. I hope I’ve given you some ideas on how you can help your donors achieve their goals by helping your charity to achieve its goals, too.