TAXATION BASICS FOR GIFT PLANNERS

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The Federal Tax System

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

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

Tax incentives to encourage charitable giving are included in both the income and transfer tax systems. However, the impact of these incentives on an individual donor varies depending upon the donor's personal circumstances. While the income tax system itself generally applies to all taxpayers, the greatest income tax incentives for charitable giving are available only to those taxpayers who itemize their deductions[1]. On the other hand, although the transfer tax affects only a very small percentage of all taxpayers – estimates are that at least 99.8% of all estates will not be subject to the Federal Estate Tax[2] – in many cases the value of estate tax incentives is greater than the value of income tax savings because, the effective Federal Estate Tax rate (40%) is higher than the highest Federal Income Tax rate (37%).

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

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

These tax savings are real. Even though the donor may not receive the savings until the following April 15 when he or she files a tax return, the reduction in the amount of tax due decreases the donor's cost of making a charitable contribution. And, since most tax rates are progressive – that is the rate rises as the taxable amount increases – the amount of tax savings is

1) The Tax Cuts and Jobs Act of 2017 substantially increased the value of the standard deduction, thus reducing the number of taxpayers who itemize deductions. About 10% of all income tax filers itemize, and therefore 90% are unable to take advantage of the charitable deduction. It might seem pointless to spend time exploring the charitable deduction since it is out of reach for the vast majority of potential donors, nevertheless there are several reasons to be familiar with the charitable deduction. First, those who itemize tend to be more affluent and therefore have the means to make larger contributions. Second, potential donors often ask about the deductibility of their contributions even if they never claim a deduction. Finally, among the quirks of the Tax Cuts and Jobs Act of 2017 is the fact that the increases in the standard deduction are scheduled to expire at the end of 2025, at which point a much greater number of taxpayers will once again be able to claim the charitable deduction.

2) According to the Urban-Brookings Tax Policy Center, fewer than 0.2% of all estates are subject to the Federal Estate Tax. The Tax Cuts and Jobs Act of 2017 doubled the amount that is exempt from the Federal Estate Tax. For those dying in 2023 a total of $12.92 million can be passed tax-free (the amount is adjusted for inflation each year). However, as with many other provisions of the 2017 law, this one expires at the end of 2025. Unless the law is changed, this could create a macabre situation in 2025: an individual who dies on December 31, 2025, will be able to leave more than twice as much tax free as he will if he survives until New Years morning on January 1, 2026.

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greater for donors in higher tax brackets. This means that the after-tax cost of making a gift is even lower for higher bracket taxpayers.

The Federal Income Tax

Ordinary Income Tax

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

Gross Income	Everything earned or received as income during the year
minus adjustments	Certain items (e.g., contributions to certain qualified retirement accounts, some business expenses, student loan interest, certain alimony payments[3]) are subtracted from gross income
Adjusted Gross Income[4]	"AGI" is a key figure that determines the maximum amount of charitable deduction that can be taken in any one year
minus deductions	Certain items, including charitable contributions, are deducted from income, however, deductions are itemized deductions only if they exceed the "standard deduction" amount ($27,700 for joint filers and $13,850 for single filers in 2023, adjusted each year for inflation) Note that taxpayers over age 65 are entitled to an additional deduction of $1,500, and $1,850 if the individual is also unmarried and not a surviving spouse (in 2023), which means a married couple filing jointly, both over age 65 would be entitled to an effective standard deduction of $30,700
Taxable Income	Amount subject to Federal Income tax

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

Federal Income Tax rates are "progressive" so that a higher percentage rate applies to larger amounts of taxable income. They are also "graduated" so that everyone pays the lowest rate on the first dollar of taxable income and only those who have larger amounts of taxable income are

3) The Tax Cuts and Jobs Act of 2017 changed the rules regarding alimony. Alimony payments ordered under divorce decrees after December 31, 2018, are no longer an adjustment to income for the payor.

4) Modified Adjusted Gross Income, or "MAGI" is used to set limits for certain other deductions and reductions, including limitations on contributions to qualified retirement plan. In general, MAGI is Adjusted Gross Income with the addition of certain items including tax-exempt income, untaxed foreign income, and the untaxed portion of Social Security income.

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subject to the higher rates. The tax "brackets" (dollar ranges at which each rate is effective) are adjusted for inflation each year.

Following are the income tax rates and income brackets for 2023:

Tax Rate	Married Filing Jointly	Single
10%	$0 – $22,000	$0 – $15,700
12%	$22,001 – $89,450	$15,701 – $59,850
22%	$89,451 – $190,750	$59,851 – $95,350
24%	$190,751 – $364,200	$95,351 – $182,100
32%	$364,201 – $462,500	$182,101 – $231,250
35%	$462,501 – $693,750	$231,251 – $578,100
37%	$693,751 and over	$578,101 and over

Note: Different tax rate tables apply depending upon the filing status of the taxpayer (e.g., single, joint, etc.).

One of the implications of the graduated tax rate system is that the "marginal tax rate" – the top tax rate which is applied to the last dollar of taxable income – is usually much higher than the "effective tax rate," the overall tax rate paid. For example, a taxpayer filing jointly in 2023 with a taxable income of $250,000 will pay a total tax of $46,800, as follows:

	Taxable Income	Tax Rate	Tax Due
	the first $22,000	10%	$2,200
	the next $67,450	12%	$8,094
	the next $101,300	22%	$22,286
	the last $59,250	24%	$14,220
TOTALS	$250,000		$46,800

A total tax of $46,800 on a taxable income of $250,000 is an "effective rate" of about 19% even though the "marginal rate" paid on the last taxable dollar earned is 24%.

After-tax Cost of a Gift

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

Example: After-tax Cost of a Gift of Cash

Assume a donor who is in the 24% marginal tax bracket contributes $10,000 in cash:

$10,000	:	Cash contributed
-2,400	:	Income taxes saved ($10,000 x 24%)
$7,600	:	After-tax cost of the contribution

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

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Notes: The example reflects Federal income tax savings only. The after-tax cost of the gift may be even less when the donor's capital gains tax and the potential Net Income Investment Tax saving are considered.

Capital Gains Tax

For our purposes, "capital gain income" is the "profit" when an investment is sold for more than it cost. It is "long-term capital gain income" if the investment was owned for more than twelve months before being sold and is "short-term capital gain income" if held for a year or less. Short-term capital gain income is taxed at ordinary income tax rates. However, long-term capital gain is taxed at lower rates: a maximum rate of 15% for most taxpayers although there is a 20% rate for higher income levels and no tax at the lowest income levels[5]

Complicating matters further, the rate for high income taxpayers might not be 20%, but actually 23.8% if they are subject to the Net Investment Income Tax (see the next section). The good news is that, of course, this decreases the after-tax cost of giving for these donors.

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

Net Investment Income Tax (the "Medicare surtax"[6]

Since 2013, taxpayers with income above a certain threshold must pay a 3.8% surtax called the Net Investment Income Tax, commonly known as the "Medicare surtax." This tax is imposed on top of the taxpayer's regular income tax.

The Net Investment Income Tax is applied to the lesser of net investment income or the amount by which Modified Adjusted Gross Income exceeds a specific dollar threshold. In general, Modified Adjusted Gross Income is the total household Adjusted Gross Income plus certain items including tax-exempt income, untaxed foreign income, and the untaxed portion of Social Security income.

5) Long-term capital gains are taxed at 15% for most taxpayers but there is a 20% rate for the higher income filers and 0% tax for lower income filers. In 2023 married couples filing jointly with taxable income over $553,850 and single filers with taxable income over $492,300 pay a rate of 20%. Married couples filing jointly with taxable income of $89,250 or less in 2023 and single filers with taxable income of $44,625 or less pay no tax on long-term capital gains. These dollar thresholds are adjusted for inflation each year.

6) A little Treasury Trivia: When it was enacted the official name of this tax was the "Unearned Income Medicare Contribution Tax," suggesting that the revenue would be used to fund Medicare. However, the revenue from this tax has never been earmarked for Medicare and has always flowed directly into the General Fund of the United States Treasury. Nevertheless, the label "Medicare Surtax" persists even though it is actually the "Net Investment Income Tax."

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The Net Investment Income Tax dollar threshold depends upon filing status. For those married filing jointly, it is $250,000 and for single filers it is $200,000. The threshold amounts are not indexed for inflation, so they will remain the same each year unless Congress modifies them with new legislation. Note that the Net Investment Income Tax can effectively increase a taxpayer's marginal tax rate which can make the after-tax cost of charitable contributions all the more attractive.

Amount of the Deduction: Fair Market Value

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

Determining the fair market value is straightforward for most contributions:

- **cash (including checks and credit cards)** – total of the cash contributed
- **publicly traded securities** – the mean (average) between the high and low prices for the securities on the date of the contribution

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

Notes:

Valuation of "non-cash" contributions has been the subject of scrutiny by the Internal Revenue Service and Congress over the years. Claiming a deduction for a non-cash contribution can trigger additional scrutiny and examination of the taxpayer's return. IRS Publication 526, *Charitable Contributions*, and Publication 561, *Determining the Value of Donated Property*, provide useful guidance. These publications are updated periodically by the Internal Revenue Service. The most current versions are available at http://irs.gov.

Substantiating the value of a charitable deduction is a matter between the donor/taxpayer and the Internal Revenue Service. Although charities should, of course, be helpful to their donors, it is best to leave the specific valuation of non-cash contributions to the donor. A good practice is for the charity to acknowledge the contribution with a complete description of the item contributed but omitting mention of a specific dollar value.

Donors should be made aware that the amount of the charitable deduction may be significantly different than the amount eventually received by the charity. For example, while the deduction for a contribution of appreciated securities will be based upon the average between the high and low prices

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

After-tax Cost of Gift of Appreciated Property

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

Example: After-tax Cost of a Gift of Appreciated Securities
Assume a donor who is in the 24% marginal tax bracket contributes securities now worth $10,000 that cost $2,000 more than a year ago (a long-term gain of $8,000):

$10,000	:	Value of securities contributed
-2,400	:	Income taxes saved ($10,000 x 24%)
-1,200	:	Capital gains tax avoided ($8,000 x 15%)
$6,400	:	After-tax cost of the contribution

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

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

Securities are the most common contribution of appreciated property. In the case of a contribution of securities, it is critical that the donor's stockbroker understand that they are to transfer the securities themselves to the charity, and that they should not sell the securities except at the direction of the charity after it has become the owner.
In other cases, for example real estate, it is critically important that there be no pre-arranged agreement to sell or buy the property prior to the contribution to charity.

Special Note: Even donors who do not itemize can take advantage of the opportunity to avoid capital gains tax by contributing appreciated property. In the above example, a non-itemizer would still avoid $1,200 in long-term capital gains tax that would have been due if the appreciated property had been sold.

Deduction Limitations

Although charitable contributions are 100% deductible for those who itemize, the maximum amount a donor can claim in any one year is limited to 60% of Adjusted Gross Income (AGI) for

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contributions of cash and 30% for contributions of appreciated property.[7] However, charitable deductions that exceed the limit in one year may be carried forward for up to five additional years.

For example, assume a generous donor has Adjusted Gross Income of $150,000 and makes cash contributions totaling $100,000 during the year. Her or his charitable deduction for the year would be limited to $90,000 (60% of Adjusted Gross Income) leaving $10,000 in unused deduction which the donor can use to reduce taxable income in the following year. (Note that taxpayers are required to use as much of their charitable deductions as they can each year. They cannot save or time the use of their charitable deductions.)

There are special rules governing the interplay between the AGI limits when a donor has contributed both cash and appreciated property in the same year. If contributions consist of both cash (60% limit) and appreciated property (30% limit) the taxpayer must first deduct all cash (60% limit) contributions up to 60% of adjusted gross income. Then taxpayer may deduct appreciated property contributions (30% limit) up to the lesser of 30% of adjusted gross income or 50%[8] of adjusted gross income minus the cash contributions deducted. This means that the limit on the total charitable deductions a donor may take in a year in which they deduct cash gifts and appreciated property gifts will be less than 60% and could be as low as 50%.

In any case, unused deductions can be carried forward for up to five years beyond the year in which the contribution was made.

For example, assume a donor with adjusted gross income of $50,000 gave her church $2,000 in cash and made a contribution of appreciated property with a fair market value of $28,000. The $2,000 cash contribution to the church is considered first and is fully deductible because it is less than 60% of adjusted gross income. Next, she is allowed to deduct $15,000 (30% of $50,000 of AGI) of the $28,000 contribution of appreciated property this year. In this case, her deduction this year is limited to $17,000. The unused portion of the appreciated property contribution ($13,000) can be carried forward for next year, and up to four additional years if necessary.
In addition, a donor may elect to have 30% contributions (gifts of appreciated property) treated as 50% contributions. However, the deduction will be limited to the cost basis of the appreciated property and the election will apply to all appreciated property contributions that year. Under certain circumstances this election may be advantageous, but this is a complex matter and the donor should be urged to consult his or her tax advisor.

Quid Pro Quo Reduction

7) The 60%/30% AGI limits generally apply to contributions to "public charities." Contribution to other charities (e.g., private foundations), while still deductible for income tax purposes, are subject to lower AGI limitations: 30% for contributions of cash and 20% for contributions of appreciated property.

8) The number 50% is not a typo. The Tax Cuts and Jobs Act of 2017 increased the AGI limit for cash contributions from 50% to 60%, however the new law did not change all of the references to "50%" and the rules regarding the AGI limits for mixed contributions still refer to 50% of AGI.

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The amount of the deduction must be reduced by the value of goods or services the charity makes available to the donor as a result of the contribution. This arises most often when the charity offers a premium or other reward in exchange for the contribution or in cases of benefit-type events. A key point is that the deduction is reduced by the *value of the goods or services, not the cost of these items to the charity*. In addition, note that it is the *availability of goods or services* that reduces the deduction, whether or not the donor actually receives or takes advantage of them. The assumption seems to be that, absent the enticement of the offer of goods or services, the donor would not have been induced into making the charitable contribution. Therefore, the mere offer of goods or services reduces the value of the deduction whether or not the goods or services are actually accepted.

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

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

Date of Gift

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

Mode of Contribution		Date of Gift
By mail	:	Postmark date (see note)
Physical delivery	:	Date delivered
Credit card	:	Date authorized by donor (see note)
Electronic/telephone transfer	:	Date completed by bank
Stock/security certificates	:	Date delivered in negotiable form
Stock/security in brokerage account	:	Date transferred to charity's account

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

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

Substantiation Requirements

It is the donor's responsibility to substantiate the fact and amount of their charitable deduction. The organization is required to provide a written disclosure statement to the donor if it receives a payment that is more than $75 and is partly a contribution and partly for goods or services. Nevertheless, charities usually make additional efforts to be of assistance to their donors. In general:

- Many organizations provide written acknowledgements for all charitable contributions even though taxpayers are not required to obtain written documentation unless the charitable deduction is $250 or more. Donors need not submit the written acknowledgement but should keep it and must produce it if requested by the IRS.
- If a donor claims more than $500 in deductions for non-cash contributions, he or she must complete Form 8283 which provides a description of the item(s) contributed and explains how the fair market value was determined. While the donor must have a reasonable basis for the claimed fair market value, an appraisal is not necessarily required (except for contributions of clothing and household goods valued at more than $500, which require a qualified appraisal substantiating the value).
- If the deduction amount is more than $5,000 ($500 for contributions of clothing and household goods), then the donor must also secure a qualified appraisal to determine the fair market value. In addition, the charity must also sign the Form 8283. Note that by signing the Form 8283 the charity *is not vouching for the value of the item(s)*, acknowledging only that it has received the contribution.
- Contributions of vehicles are subject to special rules. A donor who claims a deduction of more than $500 for a contribution of a vehicle must attach to his or her tax return a copy of a written acknowledgement, usually an IRS Form 1098C issued by the charity. The amount of the deduction is limited to the lesser of the fair market value of the vehicle or the gross proceeds from the sale of the vehicle unless the charity makes use of the vehicle for its charitable purposes.
- Although a contribution made via a Qualified Charitable Distribution (QCD) from an Individual Retirement Arrangement (IRA) is not deductible as a charitable contribution, the donor still must get a written acknowledgement of the contribution from the charitable organization. As with deductible contributions, this acknowledgement must state the date and amount of the contribution and indicate whether the donor received anything of value in return.

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

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

Gifts of Tangible Personal Property

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

"Related use" items – If the item can be put to a use that is related to the tax-exempt purpose of the charitable organization, then the donor may take a deduction for the full fair market value of the item. For example, a contribution of specialized mechanic's tools might be a related use contribution if given to a vocational school but might not be if contributed to a childcare center.

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

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

In addition, caution should be exercised when gifts of tangible personal property are accepted with the intention that they will be sold, e.g., items for a charity auction. In most cases auctioning of property does not fall within an organization's tax-exempt purpose and, therefore, items contributed with the expectation that they will be sold at a charity auction are unrelated use contributions and the deduction is limited to the donor's cost basis.

Gifts of Ordinary Income Property

"Ordinary income property" is any item which, if the donor were to sell it, would result in taxable income. The determination of ordinary income property can be very specific to the

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individual. For example, a casual collector of antique dolls is different than one who is a dealer in the same items. For the dealer, the dolls are ordinary income property, for the collector they are not.

The income tax deduction for a contribution of ordinary income property is its fair market value less any appreciation in value. Generally, this limits the charitable deduction to cost basis. These rules can be especially challenging for artists who wish to contribute their own works. In most cases an artist who contributes her or his own work will find that the charitable deduction is limited to the cost of materials.[9]

> ***Example:*** **Contribution of ordinary income property – the artist's own work**
> Assume an artist contributes a painting he has created to an art museum and that the fair market value of the painting on the day he donated it is $1,000,000. Further assume that the donor spent $500 to produce the painting (the cost of paint, brushes, and canvas), and therefore the appreciation in value is $999,500. The donor's deduction is limited to $500. However, if the same painting was contributed by an individual other than the artist, the deduction would be $1,000,000.

Non-deductible Contributions

It might seem antithetical, especially in a chapter focused on the charitable deduction, but there can be circumstances under which a donor might find it beneficial to make a charitable contribution even though there is no income tax deduction. A carefully planned contribution of ordinary income property can reduce taxable income which can provide other financial and tax savings.

For example, assume a farmer, who produces a commodity crop like corn, chooses to give a portion of the crop to charity instead of selling it on the open market. The farmer receives no income tax deduction for this charitable gift because it is a contribution of ordinary income property. However, the farmer will not receive taxable income from this portion of the crop either, so the farmer's income tax bill will be lower than it would have been had the crop been sold. Lowering the farmer's income tax bill can reduce other taxes – Social Security, self-employment, perhaps state and local. In addition, the farmer can deduct the costs of producing the crop from other taxable income.

In this example it is important to document that ownership and control of the commodity has been given to the charity, but the charity does not need to have physical custody of the crop. Commodity crops are considered to be "fungible" – each bushel of corn is like the others. The farmer can deliver the harvested crop to the local gain elevator and then, before selling them,

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9) While this rule might seem draconian, especially to the artist whose deduction is limited to the cost of materials, there is a logic to it. In the eyes of the Internal Revenue Service, the value of a work of art is simply the cost of the materials plus the value of the time and labor added by the artist. Had the artist chosen to, she could have instead used her time and labor to produce income, which would have been taxable. However, since she chose to forego the opportunity to produce taxable income she cannot then take an income tax deduction for the value of that foregone income.

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tender ownership of a certain number of bushels to the charity. The charity, as the new owner of those bushels, can then direct the grain elevator to sell them and receive payment from the sale.

Deductibility of Short-Term Capital Gain Property

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

Contributions of Capital Loss Property

Of course, investments do not always increase in value. Sometimes donors hold capital loss or "depreciated" property – investments that are now worth less than the donor paid for them. Contributions of capital loss property are usually unwise. The charitable deduction for a contribution of capital loss property will be for the current fair market value of the property, which is less than the donor paid for it.

Donors with depreciated or capital loss property should consult with their advisors about the advisability of selling capital loss property and using the loss to offset other capital gains.

Alternative Minimum Tax

The alternative minimum tax, or "AMT," is designed to ensure that everyone pays at least some income tax. It is a separate calculation, similar to the regular income tax, that disallows some regular deductions and exemptions (e.g., certain depreciation deductions, some mortgage interest expenses, excess long-term capital gains) to arrive at the Alternative Minimum Taxable Income (AMTI) which is then taxed at Alternative Minimum Tax rates. Although the AMT rates, at 26% and 28%, are lower than the highest ordinary income tax rates, the amount of tax due under AMT is often higher than the ordinary income tax for taxpayers with extraordinarily large deductions and exemptions.

The AMT was enacted in the 1960s out of a concern that some taxpayers might be able to accumulate large deductions and credits and avoid paying their fair share of income taxes. It was designed to apply primarily to high bracket taxpayers who were able to take advantage of certain tax breaks. However, over the years the AMT applied to more taxpayers because many of the thresholds in the AMT were not adjusted for inflation. In order to prevent lower-income and middle-income taxpayers from being unintentionally caught up in the AMT, taxpayers are allowed to exempt a significant amount of their income from AMT. However, this exemption is phased out for higher income taxpayers. For married couples filing jointly in 2023, the AMT exemption amount is $126,500 and begins to phase out at $1,156,300. For single filers the 2023 exemption is $81,300, with the phase out beginning at $578,150. These dollar thresholds are adjusted annually for inflation.

Transfer Taxes: Gift and Estate Tax

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The Federal transfer taxes – Estate Tax, Gift Tax, and Generation Skipping Transfer Tax – are taxes that apply when an individual transfers money, property, or other items of value to someone else. The individual (or the estate) making the gift must pay the transfer tax. Unlike the income tax, the recipient does not owe a tax because of receiving the gift.

Under the current laws, fewer than 0.2% of estates are affected by the Federal Gift and Estate Tax. A complete discussion of the complexities of the Estate Tax, Gift Tax, and Generation Skipping transfer taxes and the financial and estate planning considerations is well beyond the scope of this text. For these reasons, the following discussion is limited to an overview of key points regarding transfer taxes highlighting areas where caution should be exercised when discussing estate and gift taxes with donors.

Taxes have been levied on estates since the 18th century. Over the past two decades there has been on-going debate about transfer taxes (often called "the death tax"). Transfer taxes have been modified several times and, for one year in 2010, the Estate Tax was temporarily eliminated. In 2013, the American Taxpayer Relief Act brought more or less permanent rates and rules to the transfer tax system. However, the Tax Cuts and Jobs Act of 2017 doubled the amount that can pass tax-free.

Essentially, any transfer of value from one person to another is subject to a Federal transfer tax. However, most people are not affected by these taxes because of generous exclusions and exemptions that effectively eliminate these taxes under most circumstances:

Annual exclusion – Taxpayers can give up to $17,000 each year to as many individuals as they choose without a gift tax. In addition, payment of some expenses (e.g., certain medical expenses) on behalf of another individual can be excluded from the gift tax. The $17,000 annual exclusion amount is adjusted periodically for inflation, although not annually.[10] The annual exclusion applies to each taxpayer; a married couple can give a total of $34,000 per year without incurring the gift tax.

Lifetime exclusion – In addition to the annual exclusion amount, an individual can transfer a cumulative total of $12.92 million[11] either as gifts during lifetime or at death without either gift or estate taxes. The $12.92 million exclusion amount is for 2023 and is adjusted for inflation each year.

Spousal exclusion – An unlimited amount can be contributed to a spouse without gift tax, allowing a married couple dying in 2023 to leave a total of $25.84 million tax-free.

10) The annual exclusion amount is maintained at an even thousand number so the annual exclusion amount is not changed until the cumulative inflation reaches the next thousand. This is why the annual exclusion amount usually remains the same for three or four years.

11) Note that under current law (2023) the exclusion amount will revert to 2017 levels (adjusted for inflation) at the end of the year 2025. Essentially, the tax-free amount will be cut in half. Unless the law is changed, this could create a macabre situation in 2025: an individual who dies on December 31, 2025 will be able to leave more than twice as much tax free as he will if he survives until New Year's morning on January 1, 2026.

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Charitable deduction – There is an unlimited deduction from transfer taxes for contributions to charitable organizations.

Unified Gift and Estate Tax Rates

The amount of tax due on a taxable transfer is calculated using the "Unified Gift and Estate Tax Rate Schedule." Like the income tax, the Unified Gift and Estate Tax rates are progressive, beginning at 18% and ranging up to 40% beginning on taxable transfers of $1.0 million. Since, under current law, there is no tax until taxable estate exceeds $12.92 million, as a practical matter taxable transfers are taxed at a flat rate of 40%.
Although it is commonly said that estates under a certain dollar amount are "tax free," in fact the Federal Gift and Estate Tax system provides a tax credit that covers the tax due on transfers below the lifetime exclusion amount (sometimes referred to as the "unified credit equivalent" amount). It is the application of this tax credit that results in the "tax-free" transfer – it is not really "tax free," rather it is that the tax due is paid by the credit.

Gift and Estate Tax Summary

Up to $17,000 per year	-	Can be given to each of an unlimited number of individuals (a married couple can give $34,000)
More than $17,000 per year	-	File a Federal Gift Tax Return and pay 40% tax when cumulative lifetime gifts exceed $12,920,000*
Up to $12,920,000* in total lifetime and estate giving	-	No Federal Gift or Estate Tax
More than $12,920,000*	-	Total value of combined taxable lifetime and estate giving in excess of this amount is taxed at 40%
* Note: The $12,920,000 exclusion is the threshold for 2023 and is adjusted for inflation each year. The $17,000 annual exclusion is the threshold for 2023 and is adjusted from time to time (but not necessarily annually).		

Stepped-up Basis versus Carry-over Basis

There is an important difference in the way capital gains are treated depending upon whether individuals make the gift while they are alive versus through their estates.
When a recipient sells appreciated property that was received as a gift from a living individual, the recipient must pay capital gains tax on all of the appreciation in value based upon the donor's cost basis. This is called "carry over basis."

However, if a recipient sells appreciated property that was received from an estate, capital gains tax is due only on the appreciation since the date of death. This is called "stepped-up basis."

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

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Generation-Skipping Transfer (GST) Tax

The Generation-Skipping Transfer Tax (GST) is designed to prevent wealthy taxpayers from avoiding one or more levels of taxation by leaving substantial amounts of money or property to grandchildren instead of children, thus skipping the tax that would have been due if they had left it to their children who then left it to the younger generation. In general, the GST taxes generation skipping transfers as though the transfer had first gone to the intervening generation. For example, if a grandparent transfers to a grandchild, the Generation Skipping Transfer Tax would essentially double the tax as though the transfer had been made from grandparent to parent to grandchild. The GST applies to any heir who is more than 37.5 years younger than the deceased.

State Taxes

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

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

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

State income tax is deductible from Federal taxable income. However, the Tax Cuts and Jobs Act of 2017 established a $10,000 annual ceiling on this deduction. State estate taxes are deductible when calculating the Federal Gift and Estate Tax.

Split-Interest Charitable Gifts

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

These are called "split interest gifts" because the donor has split the ownership interests in the item and contributed the right to hold and own it from the right to enjoy it – either collect income

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or, in the case of a retained life estate, live in it. The donor is entitled to a charitable deduction for a split interest gift, but the amount of the deduction is only for the value of the portion contributed, not for the entire value of the item contributed.

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

As a rule of thumb for life income gifts:

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

Substantiating the Deduction

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

- A description of the contribution, including a copy of the gift instrument (e.g., trust agreement, gift annuity contract)
- The valuation and date of the transfer
- The names, birthdates, and Social Security numbers of the beneficiaries
- A summary of the calculation of the deduction amount including the interest rate used to value the transferred interest

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