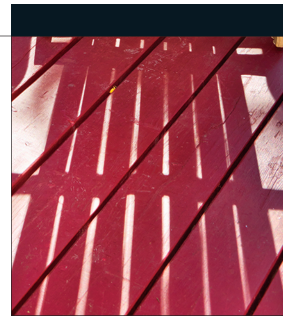

Tax-Advantaged Year-End Charitable Planning Strategies

Clients can provide greater financial assistance to charity without increasing their donation budgets by making use of tax-favored charitable giving strategies.

LAURA J. MALONE

As the holiday season approaches, many estate and financial practitioners—such as financial/wealth advisors, attorneys, and tax/accounting advisors—find themselves in that "holiday crunch-time." While one may think that phrase has to do with holiday shopping and gift giving, in this case, it is more directly correlated to year-end tax and estate planning. Many practitioners focus on discussing charitable giving as a planning strategy in the estate planning context and may fail to discuss these planning strategies as an annual income tax planning strategy. As a result, those practitioners and their clients could be missing out on valuable opportunities.

The clients may miss the ability to maximize income tax benefits in a way that will help them create more charitable leverage to support their favorite charities, while the practitioners may miss opportunities to differentiate themselves as a thought leader, create added value, and build more trust with the client that may produce inroads to the subsequent generations. The discussion that follows explores some simple charitable opportunities that can be introduced to clients in connection with their year-end planning.

Annual charitable giving as a strategy

Charitable giving is a significant aspect of the American mindset. Organizations like Giving USA and Atlas of Giving estimate last year's charitable giving to be between $335 and $418 billion. While not all of that giving is typically itemized on donor tax forms, the 2011 Statistics of Income (SOI) by the IRS reports that the charitable deduction is the third largest deduction after taxes and interest paid.[1] Based on itemized deductions in that same report, more than 37.7 million individual taxpayers gave about $174.5 billion to their favorite charitable causes, with more than 45% of those dollars coming from households with $200,000 adjusted gross income or higher.

It is estimated that most clients make their charitable gifts in cash, without considering the use of appreciated investments they may hold. In fact, according to the IRS SOI Bulletin for Noncash Charitable Contributions, less than 130,000 households reported itemized gifts of corporate stock, mutual funds, or other investments on their Form 8283.[2]

When clients fail to think of their charitable giving as a strategy, they miss the opportunity to leverage some of their highly appreciated assets, such as corporate stock, mutual funds, or other investments.

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As such, they may be missing multiple income tax benefits including:

1. Maximizing the immediate income tax deduction in the year the contribution to charity is made. In most instances, clients may deduct up to 50% of their adjusted gross income (AGI) for gifts made to a public charity and up to 30% of AGI for securities and other appreciated assets. If the gift exceeds these deduction limits, the excess is eligible for a five-year carry-forward.[3]
2. Incurring no capital gains tax with respect to the gifts of appreciated assets (e.g., securities, real estate, and other illiquid assets) even when they can deduct the gift's full fair market value.
3. Reducing their alternative minimum tax (AMT) exposure, if the taxpayers making the charitable contributions would otherwise be subject to AMT.

By not thinking more strategically about charitable giving, clients may miss more than just tax savings; they may miss the opportunity to leverage their charitable giving in a way that helps them to do more for their charities with less out-of-pocket costs to themselves. Through the use of giving vehicles like donor-advised funds (DAFs), private foundations, and charitable trusts, they may also be able to leverage larger assets like real estate, privately held stock or other assets that may be more complex. They can then use those assets over the duration of their lifetime when it may be important to see, enjoy, and share with their loved ones the "charitable fruits" of their giving. Furthermore, they may underutilize charitable giving as a teachable instrument during their lifetimes to educate and train their heirs about their family values and fiscal responsibility.

As practitioners, it may be important to note that clients apparently are becoming more concerned about the benefits of charitable giving done during their lifetime rather than after they are gone through their estate plans. In an update of a previous study, The Boston College Center on Wealth and Philanthropy reported recently that an estimated $59 trillion may be transferred from 116 million American households between 2007 and 2061, with an estimated $6.3 trillion going to charity.[4] The report further notes that analysis of Federal Reserve data indicates an increase in the assets transferred out of the household portfolios of older, affluent households which was not evident before the millennium. This includes noted increases in the gifting to and asset values of private foundations, DAFs, and charitable trusts.

Appreciated securities donation

Many individuals have stated that the tax deduction is not the main reason why they give, and they may not be viewing these tax savings as a way to increase the benefit to their charities of choice. By raising the idea of how charitable tax savings can create more giving capacity, practitioners can sometimes pique a new interest in the minds of clients.

Example. A client makes a $10,000 gift annually to a charity. Regardless of whether the gift is $10,000 in cash or stock, the client's deduction is $10,000, which saves $2,500 in the 25% tax bracket. (Any state income tax savings is an added bonus.)

If, however, the client has $10,000 worth of publicly traded XYZ stock that the client bought more than a year ago for $5,000, additional benefits can be reaped by gifting the stock as opposed to selling the stock. Even assuming a 15% preferential capital gain tax rate, the client would owe $750 in tax on gain from the sale of the stock. If the client instead donates the shares, the charity would get the full $10,000 (as it does not owe tax

1 Bryan, "Individual Income Tax Returns, 2011," 33 SOI Bulletin 5 (Fall 2013), available at www.irs.gov/pub/irs-soi/13inreturnsfallbul.pdf.

2 Liddell and Wilson, "Individual Noncash Contributions, 2011," 33 SOI Bulletin 111 (Spring 2014), available at www.irs.gov/pub/irs-soi/14insprbulnoncash.pdf.

3 Sections 170(b)(1) and (d)(1).

4 Havens and Schervish, "A Golden Age of Philanthropy Still Beckons: National Wealth Transfer and Potential for Philanthropy Technical Report," Center on Wealth and Philanthropy, Boston College, 5/28/2014, available at www.bc.edu/content/dam/files/research_sites/cwp/pdf/A%20Golden%20Age%20of%20Philanthropy%20Still%20Bekons.pdf.

on the profit when it sells the stock) and the client would avoid the $750 tax bill. Nonetheless, the client would still be able to deduct the full $10,000 value of the stock.

The client could then take the $10,000 of cash that he or she was thinking of donating to the charity and instead use it to repurchase shares of XYZ stock. As a result, the client would have "reset" the basis of that stock from $5,000 to $10,000 and would have avoided the corresponding taxable capital gain when that stock is sold in the future. This strategy may allow some clients to increase their giving by as much as 30% if they evaluate their gifting at the "after-tax" cost instead of the "before-tax" cost.

"Prefunding" charitable giving

While many estate and financial practitioners may use prefunding strategies to help clients plan for their retirement or their children/grandchildren's college education, the idea of prefunding is not often discussed as a way to leverage charitable planning. This may not be ideal for younger clients who are still in their wealth accumulation years, but is better suited to clients who are approaching retirement and in their final higher-income earning years. They are beginning to look at how to budget for their upcoming fixed income that may be less than what they had been making in the past.

As important as charitable giving may be to them, they may be considering reducing their giving in the future because of their new budget constraints. If they maximize their giving into a vehicle like a DAF during their final higher income years, they may not need to reduce their future giving.

Example. The facts are the same as in the previous example, except this is one of the client's last high-income earning years before beginning retirement. The client may want to consider pre-funding his or her next five or more years of charitable giving by putting $50,000-$100,000 into a DAF today. Doing so would get the client a large immediate income tax deduction while continuing to provide the charity annually with $10,000 a year to the client's charity of choice. As with the earlier gift, the client would net savings this year on the charitable gift and the avoidance of capital gains tax. Furthermore, if the client's adjusted gross income is high enough, he or she may also avoid the 3.8% net investment income tax on investment income.

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Another thing to keep in mind is that some clients may have a high concentration of a stock that is highly appreciated. Sometimes because of an emotional connection or business reason, they may be hesitant to sell or gift the stock. Depending on the charity or DAF sponsor, those shares may be able to remain held as an "in-kind" investment.

This same strategy may be beneficial to someone who received an inheritance, is making a Roth conversion, or has some other type of one-time liquidity event that creates a single-year spike in income. Prefunding charitable giving can offset the increase in AGI caused by that liquidity event.

Gifting closely held or complex assets

A lot of attention has been given in past years to The Giving Pledge, a commitment by some of the world's wealthiest individuals and their families to dedicate the majority of their wealth to philanthropy.[5] In some of these cases, most of that charitable giving will take place after the donor's death as part of his or her estate plan. While the Pledge focuses on some of the wealthiest in business, many smaller business entrepreneurs are equally dedicated to supporting their local communities through charitable giving. In fact, studies have shown that entrepreneurs donate at a proportional rate of more than double their larger, corporate counterparts.[6] Often this giving is done while the owner is actively engaged in the business and continues as the owner prepares to leave the business.

The business is often the owner's greatest asset. This highlights the importance of practitioners suggesting opportunities for the owners to leverage some of the benefits of gifting interests of closely held enterprises (e.g., C or S corporations, limited liability companies or partnerships, real estate holdings, or other more complex assets) before the owner transitions those assets in a sale to heirs or a third party. Often, owners wait until after the sale of their business holdings to make charitable gifts. However, if all or a portion of these assets are gifted before the sale, the owner can save on capital gains taxes in the same way he or she would a gift of publicly traded assets. Addi-

5 http://givingpledge.org/.

6 "Entrepreneurs are More Likely to Give to Charity," Fidelity Charitable Press Release (11/12/2010), available at http://www.fidelitycharitable.org/about-us/news/11-12-2010.shtml.

7 Section 170(e)(1).

8 Section 170(b)(1)(F).

9 Section 170(f)(11).

tionally, if those assets are given to a public charity or DAF, the client gets a fair market value deduction for the gifts of these assets[7] instead of a cost basis deduction as would occur if the gift was to a private foundation.[8]

In order for the gift to be recognized at fair market value (FMV), the gift has to be made to the public charity or DAF before any willing buyer or seller is required to act on the sale. Also, if the donor puts a restriction on the use of property, the FMV must reflect that restriction. For these types of gifts, the IRS requires a qualified appraisal for any gift over $5,000. This appraisal must be made by a qualified appraiser, and the donor must attach Section B of Form 8283, Noncash Charitable Contributions, to his or her tax return.[9]

Because of these IRS requirements, most owners may elect to donate nonvoting shares of their closely held stock or a small enough percentage of the asset that the owner still has majority control. While traditionally the desire for control has had owners specifically seek out private foundations in these charitable gifts, some public charities and DAFs offer a great deal of flexibility in this process. Often, the charitable organization has no desire to be active in the ownership of a business, the organization simply wants potential liquidity from the sale, the same end-result as the owner desires.

Leveraging DAFs, private foundations, and charitable trusts

Over the last decade, the growth of DAFs has been increasing at a rapid rate. Many individuals, families, and companies are being drawn to DAFs by their simplicity. Because the sponsors of DAF programs are Section 501(c)(3) public charities, the client can receive a tax deduction at the same level of consideration as any gift to any other public charity (up to 50% of AGI gifts in cash and 30% of AGI for gifts of appreciated securities, mutual funds, real estate, and other assets). DAFs have become extremely helpful when the client wants to leverage a larger gift today and distribute that gift into smaller portions over a longer period. This may also include when the client is trying to donate more complex assets like real estate, mineral and gas rights, or closely held stock.

It is important for the client to evaluate each DAF sponsoring organization and evaluate how well it satisfies the donor's specific needs. While some DAF programs are extremely flexible, a significant number of programs have limitations on both the type of assets that can be gifted to the DAF and how the assets are managed. Other programs may limit how many successive generations the client can name to make grants from the DAF and what organizations or charitable causes may be supported through the DAF. Not all sponsoring organizations have the capacity to accept or hold complex asset gifts like real estate, closely held stock, or gas/oil/mineral rights.

While DAF popularity is growing, private foundations are still larger, with about $61 billion in overall assets.[10] In some cases, there are still good reasons for individ-

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uals, families, and companies to create their own private foundations. While DAFs can be extremely flexible and easy to administer, there will always be the desire for the control that comes from the creation of an independent legal entity. The client may want to consider a broader purpose than making grants to public charities and other types of nonprofit organizations. For instance, the donor may want to be more hands-on in the choice of scholarship recipients than is possible in a DAF.

Prefunding charitable giving can offset the increase in AGI caused by that liquidity event.

Some clients may want to run their own charitable programs or make grants directly to individuals for disaster relief and economic hardship. Some clients may like the idea of hiring staff or being able to recoup expenses and compensate family members for their services they perform on behalf of the private foundation.

While historically the choice between private foundation and DAF might have been evaluated by the size of the gift the client is willing to contribute, more frequently it seems to be based on its intended use and the desired involvement and outcome expected by the client. Because in some situations a DAF may be better than a private foundation and vice versa, the possibility for a best of both worlds scenario where both vehicles can be used in tandem with each other may give the clients the maximum flexibility to fulfill their desired goals.

Another "win-win" strategy with clients can sometimes be pairing a DAF or private foundation with a charitable trust. Charitable remainder trusts (CRTs) allow the client to put money or assets (except for S corporation shares) into the trust and receive income for either a lifetime or term of years. Whatever income is not received by the client during that time frame then goes to the charity, DAF, or private foundation. CRTs are sometimes combined with business sales or other large liquidity events. Charitable lead trusts (CLTs) are often used when a client wants to protect an asset and have the asset transition either back to the client or to his or her heirs after a term of years. Inversely from the CRT, the charity, DAF, or private foundation will get the income payments during that term of years.

Once the term is complete, the asset goes back to the grantor or the heirs without them having to pay taxes on the appreciation of the asset. By pairing either of these vehicles with a DAF or private foundation, the family may still be able to direct the charitable capital on their preferred timetable to whatever charities they care to support.

Why incorporate these discussions into estate planning practice?

Most practitioners feel capable of discussing charitable giving from a technical perspective, like tax considerations or wealth structuring, but still might be underserving their clients. A growing number of individuals seem to be expressing a desire to learn more about the nontechnical aspect of charitable planning. They expect that education to come from their trusted practitioners.

In August 2013, U.S. Trust and The Philanthropic Initiative surveyed both practitioners who service high-net-worth (HNW) families (financial/wealth advisors, attorneys, and tax accountants) and HNW clients who are actively engaged in charitable giving or philanthropy.[11] The study found a discord between how advisors and clients view the level of engagement and focus of their conversations around charitable giving.

While most advisors (89%) say they discuss charitable giving with at least some of their clients, half of the HNW individuals (51%) say that they were the one to initiate the conversation. In addition, many HNW individuals indicated that the tax benefits were less important than the desire to encourage charitable giving by the next generation (30%), the desire to fulfill religious or spiritual motivations (23%), or the belief that giving back is an obligation of wealth (22%). Furthermore, only 14% of advisors are likely to raise the topic of charitable giving with clients for the purpose of helping to instill charitable values among the client's children and grandchildren.

While nearly half (45%) of HNW individuals feel it is important to involve children and grandchildren in discussions with their advisor about charitable giving, however, just a fraction say that their practitioners have suggested including future generations in giving. Similar to the previously mentioned Boston College study, clients expressed concern about charitable giving policy changes in estate and income tax planning, 6% and 45%, respectively. This suggests added motivation for practitioners to move the charitable discussion

10 "SOI Tax Stats—Domestic Private Foundation and Charitable Trust Statistics," available at http://www.irs.gov/file_source/pub/irs-soi/10pf01ta.xls.

11 "The U.S. Trust Study of The Philanthropic Conversation: Understanding Advisor Approaches & Client Expectations" (October 2013), available at http://www.tpi.org/sites/files/pdf/us_trust_study_of_the_philanthropic_conversation_2013_final_report.pdf.

to more an annual planning topic instead of just an estate topic.

Those advisors who step beyond the technical discussion of charitable giving and take the time to question clients about the meaning, intention, and values of their giving tend to believe it is good for their business development. Some practitioners have seen benefits that tie into the creation of a more comprehensive, holistic approach to the client's needs as well as helping them attract new clients. Many practitioners feel that these discussions deepen relationships and can help expand relationships to extended family, a benefit many practitioners seem to be seeking in order to keep their practices thriving.

Suggest strategies early and often

This time of the year is the perfect opportunity to examine which clients may have an interest in or could benefit from some of the strategies discussed above. Practitioners with insufficient knowledge about their clients' charitable interests or intentions should start with those clients who are married without children, have never married, or have lost a spouse or partner. Often they have the extra time and resources to be actively engaged in their community.

Practitioners may want to consider incorporating charitable questions into every meeting regarding what organizations the client supports and why, in order to understand more about their values. Inquiring about what makes clients choose how much they give may help to establish if they would be open to strategies that would help them be better givers. If clients have discussed concerns about their children and wealth, ask them if they have ever thought about getting their children or other heirs involved in their charitable-giving activities.

Some practitioners may not realize that their clients may have already created a DAF or a private foundation on their own. Has the client thought about leveraging those vehicles and comparing the results of their giving now vs. funding them and making charitable gifts after the client is deceased?

Conclusion

The holidays create a natural opportunity for the discussion of giving, meaning, and values. One of the added benefits of starting this conversation now is that most charities are already talking to clients about year-end and holiday giving campaigns. Bringing up these discussions may help uncover added ways the clients can participate in those charitable appeals. With a little time and effort, practitioners can use these year-end discussions about charitable strategies to turn holiday crunch-time into added holiday cheer for their clients, their communities, and themselves. ■