

**PRACTICAL WAYS TO
TALK WITH DONORS ABOUT
CHARITABLE GIFT PLANNING**

Scott Blakesley

Spencer Fane Britt & Browne LLP
1000 Walnut, Suite 1400, Kansas City, Missouri 64106
Phone: (816)292-8268 -- E-mail: sblakesley@spencerfane.com

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I. INTRODUCTION

A. There are Options Other Than Current Cash Gifts.

1. Although we all like and appreciate the current cash gifts, we need to be open to other alternatives.

2. One of the alternatives is incorporating charitable giving as part of the plan for disposition of assets in the future (often referred to as “estate planning” or “planned giving”).

3. Charitable distributions are often overlooked as a topic of discussion when a donor meets with his or her legal and financial advisors – so it may be up to the charities to encourage these discussions.

B. Gift Planning Is Not Limited to the Wealthiest Donors.

1. Certainly, the most significant charitable plans often come from the wealthiest donors.

2. However, it is a mistake to assume that charitable bequests and other gift planning will not be appropriate for the moderately wealthy and/or those who have very little.

3. The simplest and most common form of charitable plan is accomplished through a bequest in a Will or Trust Agreement (as discussed below), and it is not unusual to see some kind of charitable bequest (possibly contingent) being included as part of the planning for many donors – even those with a more modest net worth.

4. Sometimes, the wealthiest donors can afford to do more charitable giving during lifetime, so they don’t feel as inclined to include charitable bequests at death; while the donors with less wealth may not have the luxury of making lifetime charitable gifts, and see a testamentary bequest as the best (or only) way for them to carry out their charitable intentions.

II. BRIEF REVIEW OF RELEVANT TAX RULES.

A. Important to Be Aware of the Rules (even if though they are currently uncertain).

1. It is always difficult to predict what Congress and the IRS may do to the “rules of the game” at any time.

2. In 2001 (through the Economic Growth and Tax Relief Reconciliation Act) Congress put into place a supposed “repeal” of the estate tax that would gradually come into being in 2010. However, for monetary and political reasons, the 2001 Act included a “sunset”

provision so that the repeal would end after 2010, and the estate tax would automatically be re-established in the year 2011 if Congress took no further action.

3. There is no certainty (of any kind) as to what Congress may or may not do with the tax laws in 2010 or 2011. In light of these uncertainties, these materials (and the author) is making the assumption that there will be an estate tax beginning in 2011. The “Tax Exempt Amount” referred to below is a reference to (a) the \$3,500,000 Exempt Amount available in 2009, (b) the \$1,000,000 Exempt Amount that will be with us in 2011 if nothing is done by Congress, or (c) whatever other number (including \$0) that may be applicable at any given time in the future. These materials also assume the Estate Tax rate is 45%, although this could also change.

B. Estate & Gift Tax Charitable Deduction.

1. The Transfer Tax deduction is 100%, and is the same regardless of the type of charity to which the gift or bequest is made (unlike under the income tax rules where there is a difference between gifts to public charities or private foundations).

2. Note: If the estate tax is paid out of the charitable portion of an estate (or Revocable Trust), there is an interrelated calculation. Each dollar of estate tax reduces the amount passing to charity, which reduces the charitable deduction, which further increases the estate tax amount, which further decreases the charitable deduction . . .

C. Income Tax Charitable Deduction.

1. The annual income tax deduction that can be utilized for gifts to charity is limited to a percentage of the donor’s Adjusted Gross Income for the year, as follows:

- Gifts of cash to public charity allowed up to 50% of AGI.
- Gifts of other assets to public charity limited to 30% of AGI (or 50% of AGI if election made to limit the deduction to the asset’s cost basis).
- Gifts of cash to private foundation limited to 30% of AGI.
- Gifts of other assets to private foundation limited to 20% of AGI.
- Also: for gifts to a private foundation, the income tax deduction is limited to the cost basis of appreciated assets other than marketable securities.

III. PRACTICAL USE OF CHARITABLE BEQUESTS IN WILLS AND TRUSTS

A. General Comments.

1. Bequests represent a substantial portion of planned giving support for charities, and are relatively easy to implement.

2. Be aware that many donors may prefer to avoid discussions about donations that are effective at death, because they don't like to think or talk about "death" (perhaps even more than they dislike talking with lawyers or thinking about taxes).

3. However, the focus can be on the alternatives for how a donor can provide support to a charity they care about (rather than the "death and taxes" discussion).

4. Make sure there is obvious information on your web site (or other materials) that make it clear how to name your charity as a beneficiary.

B. Alternatives Related to Timing.

1. This may be the most critical planning issue, because the concept of "timing" can sometimes open the door to discussions about charitable giving that might not otherwise take place.

2. Often, the discussion of potential charitable provisions in a will or trust begin with a discussion of what happens for purposes of the "default" distribution (if the donor's anticipated beneficiaries are not living).

3. As part of the estate planning discussion, any one or more of the following alternatives may be attractive:

- a. At the Donor's death, regardless of family members who might survive.
- b. At the Donor's death only if the spouse does not survive (when the balance of the assets are passing to the descendants or trusts for their benefit).
- c. At the Donor's death only if the spouse and none of the descendants survive (in lieu of assets passing to more remote heirs). This is probably the most common scenario, and is one that should at least be considered by every donor. This is also the concept that is often overlooked by the donor and his/her advisors when considering what provisions to include in a Will or Revocable Trust.

C. Alternatives Related to Format.

1. “All of my estate” (these are the ones the charities dream about).
2. specific dollar amount or asset [i.e. “I give \$50,000 to ABC Charity”; or “I give all my Wal-Mart stock to XYZ Charitable Foundation”].
3. A percentage of the estate [i.e. “I give 25% of my estate to ABC Charity”].
4. “All of my estate in excess of \$_____.” This can be done for non-tax reasons (as part of the discussion relating to how much is enough for the family), but can also provide some interesting estate tax benefits because it may discourage the IRS from arguing valuation (the government will not collect any more tax if the asset values are increased).

D. A Key Concept: How Much is “Enough” for the Family?

1. Some donors might consider how much is “enough” for the children, and give the rest to charity.
2. Donors often have a fear that giving their descendants “too much” will spoil them, and result in the descendants not having any motivation to provide for their own support. This type of planning may not be motivated by charitable intent or by taxes, as much as by a desire not to give too much to the children – with charity becoming the logical default.
3. The determination of how much is “enough” or “too much” varies from family to family, and person to person. The specific amount is not as important to understand as the general idea that there may be such a limit – and this is a way to consider how assets should be allocated.
4. The “excess” amount could also be set aside in a special type of charitable fund that allows the children to continue to be involved in the future distribution decisions. [This can be the case with some “donor advised” funds that can be held within a charity’s endowment fund accounts.] In these situations, the charitable bequest may be viewed by the donor in a new light. The donor may see this as a nice compromise, because the charitable bequest does not take the assets away from the children, but merely “earmarks” some portion of the assets for charitable purposes, to be determined in the future by the children.
5. Note that, if the amount passing to family is limited to a finite number, some of the usual estate tax planning ideas may no longer be important for this donor because the estate tax exposure is fixed based on the amount passing to the family (and any increase or decrease in the size of the gross estate will not affect the amount of estate tax).

E. Disclaimers by Children Funding Charitable Amounts.

1. One alternative that works well in some situations is to leave it up to the children to decide the portion of the assets (if any) that will pass to charity rather than passing to the children or trusts for the children.

2. This can be handled through a provision that contemplates the potential for a disclaimer by one or more of the children. The will or trust agreement states that any disclaimed portion will pass to charity, and the child can then wait until after the parent's death to decide how much is appropriate (assuming the decision is made within the nine month time period for a qualified disclaimer under federal tax law).

IV. USING RETIREMENT ACCOUNTS FOR CHARITABLE BEQUESTS

A. Beneficiary Designations as Substitute for a Bequest

1. For the tax reasons explained below, it is often best to provide for a charitable "bequest" to actually come from an IRA or other retirement plan account.

2. This is an opportunity that is often overlooked by the donors and their advisors. Charitable planning through IRAs and other retirement plan accounts may take some additional effort and understanding, but the results can be significantly better.

4. For purposes of this discussion, the term "Retirement Account" includes any (a) Individual Retirement Account ("IRA") other than a Roth IRA (that does not carry income tax liability); (b) Profit Sharing, 401(k) and 403(b) Plans; and (c) any other deferred income benefit which will be subject to income tax when distributions are received.

B. General Income Tax Considerations

1. Once received by the participant or named beneficiary, distributions from a Retirement Account are subject to income tax at ordinary income tax rates. Even though there is an income tax deduction for the federal estate tax payable on Retirement Account benefits received, the inherent tax liability means that a Retirement Account may not be as valuable to the children as might be anticipated.

2. There is also a problem if the participant's Estate or Trust uses the Retirement Account to satisfy a specific bequest after the participant's death (including a charitable bequest).

a. Distribution of the Retirement Account to satisfy the bequest (if not specifically directed) is treated as a sale or exchange, and the Estate or Trust will recognize taxable income at the time of the distribution.

b. A better approach is to provide in the Will or Trust Agreement that the Retirement Account is to be distributed to the intended charity, and then use cash to satisfy any shortage. If the Retirement Account (or any other IRD item) is distributed as a special bequest, the income tax is not realized by the Estate or Trust.

c. Usually, the best approach is to name the intended charity directly under a beneficiary designation for the Retirement Account, and then have the Will or Trust include a supplemental bequest (if needed) to bring the total amount up to the intended bequest.

C. General Estate Tax Considerations

The value of the Retirement Account is included in the gross estate at the participant's death, and the estate tax value is not reduced by the fact that the Retirement Account assets will be subjected to income tax upon receipt (although there is an income tax deduction for the amount of estate tax paid). The Estate Tax Charitable Deduction can eliminate the estate tax otherwise payable at death, if the Retirement Account passes to charity.

D. Impact of Minimum Distribution Rules.

The Minimum Distribution Rules found in the Treasury Regulations under IRC Section 401(a)(9) are rather complex and are beyond the scope of these materials. However, the following points are worth noting with respect to how these rules are affected by the inclusion of charity in a beneficiary designation.

1. If a charity is a direct beneficiary of all or part of the Retirement Account at the participant's death, this no longer affects the timing of distributions that must be made to the participant during lifetime (which are now based on a uniform table that generally is not affected by the identity of the beneficiary).

2. For purposes of the required payments after a participant's death, including a charity may mean that there is no "Designated Beneficiary" – and this would normally eliminate the ability to pay out the proceeds over the life expectancy of the other beneficiaries following the participant's death.

3. However, if the portion or amount for charity is paid out before September 30 of the year following the participant's death, the existence of charity is ignored in determining the Designated Beneficiary' which means the remaining beneficiaries would be able to elect to receive payments over their life expectancies.

4. Payments to charity at a participant's death avoid the need to worry about all the complicated Minimum Distribution rules otherwise applicable to Retirement Accounts.

E. Example of Combined Estate and Income Tax Impact:

1. Assume a decedent has \$1,000,000 in a Retirement Account that will be taxed at the highest estate tax and income tax rates; and the Retirement Account is distributed to the children at the participant's death.

Value of Retirement Account	1,000,000
Estate Tax Payable (45%)	450,000
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Income Distribution from IRA	1,000,000
IRD Deduction	- 450,000
Taxable Income after 691(c) deduction	550,000
Fed/State Income Tax Payable (40%) *	220,000
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Total Estate and Income Taxes – 67%	670,000
Net to Children – 33%	330,000

* Although the income tax portion can often be spread over the life expectancy of the children (“stretch” distributions), the taxes will eventually have to be paid. Beginning in 2011, the combined tax liability may be in excess of 72%

4. Donors can be told that for every dollar they leave to charity at death, the government pays approximately 67% of the cost (because this is what would have to be paid in income and estate taxes if the Retirement Account passed to the children). This is very attractive to many, and can “motivate” otherwise dormant charitable intent.

5. Even when you eliminate the estate tax (for the smaller estates), the tax cost of leaving the Retirement Account to the children is around 30% - 40% (depending on the income tax rates of the children).

F. Structuring Beneficiary Designation for Best Tax Results.

1. Most often, a person will include a bequest to charity in his/her Will or Revocable Trust, and then leave the Retirement Account to the children (if there is no spouse), either intentionally or by default (due to lack of careful planning).

2. The result of this “plan” is to give the children an asset that has a built in income tax liability, which reduces the “real” value of what the children receive.

3. A better alternative is to leave the Retirement Account to charity and the other estate assets to the children under the Will or Trust. When the charity gets the Retirement Account, the charity does not pay income tax, so the charity receives the full value of the Retirement Account. The children receive assets from the Estate or Trust that will not usually be treated as taxable income.

4. By making this simple switch, the children receive 30% - 40% more value than if they were to receive the Retirement Account distribution.

Example: Assume a decedent with no spouse has \$100,000 in an IRA and \$100,000 in a cash account, and the goal is to provide \$100,000 to charity and \$100,000 to children. The “usual” way this is done (unfortunately) is to include a \$100,000 charitable bequest in the Will (or Revocable Trust) and leave the IRA to the children. Under this method, the children will receive \$100,000 but will have to pay income tax of up to \$40,000, leaving only \$60,000 after tax. If the bequests are reversed, the children will receive \$100,000 that is not income and the charity will receive the distribution from the Retirement Account – but the charity will not have to pay income taxes on the amounts received from the Retirement Account. The result is that the Government does not receive an unintended share of the assets.

5. Getting away from the over-simplified example above, we should try to arrange for any charitable bequest in a donor’s will or trust to instead be made from the Retirement Account – and can then include a provision in the will or trust agreement to make the charitable distribution to the extent the Retirement Account is not sufficient.

G. Retirement Account to CRT.

1. In general, a Charitable Remainder Trust (“CRT”) is a trust that provides for payments to individuals for life or a period of years, after which the remaining assets in the CRT pass to charity. The CRT is a “tax-exempt” entity for income tax purposes.

2. If the entire balance in the Retirement Account is paid to a CRT at the participant’s death, the participant’s estate will be entitled to a partial estate tax charitable deduction for the value of the remainder interest.

2. More importantly, the CRT will receive the entire balance of the Retirement Account in a lump sum (with no immediate income tax), and future payments to the CRT income beneficiary will be based on the provisions of the CRT (payments based on a fixed dollar amount or percentage of the CRT value) rather than having to use the Minimum Distribution Rules which are designed to totally liquidate the account balance during the beneficiary’s lifetime.

3. This can sometimes be a “safer” approach than using “stretch” distributions through a beneficiary designation, because the beneficiary cannot elect to take a lump sum. This can also prevent “undesirable” beneficiaries at the death of the primary beneficiary.

4. The Estate Tax payable as a result of the payment to the CRT should be paid from sources other than the Retirement Account – otherwise there is a complicated interrelated calculation which will result in much less passing to the CRT.

V. EFFECTIVE PLANNING WITH LIFE INSURANCE

A. Life Insurance for Direct Benefit of Charity

1. Life insurance payable to charity at death can provide a significant financial benefit to charity without much of an impact on the family inheritance.

2. Some donors like the simplicity of this arrangement if they can afford the cash flow needed to pay the premiums.

3. No income tax deduction for premiums unless the insurance policy is owned by the charity when the premium is paid.

B. Insurance Proceeds to Replace Family Wealth (“Wealth Replacement”).

1. Perhaps a more effective method is to have the life insurance payable to the children (or other family members), to “replace” or substitute for the value of the assets passing to charity through lifetime or testamentary charitable gifts – or simply as an estate tax free method for providing for the family, leaving the other assets available to leave to charity.

2. Because it is relatively easy to remove the life insurance from estate tax liability – through an irrevocable insurance trust or having the children own the policy – it is generally better to have the life insurance pass to the family and have other assets pass to charity.

C. The Ultimate Plan to Pay No Estate Tax.

1. With a combination of life insurance and charitable bequests, it is possible to entirely avoid any estate tax liability (regardless of what Congress may decide to do with the Estate Tax rules).

2. The donor arranges for the purchase of a large life insurance policy which is owned by the children or an Irrevocable Trust for their benefit.

3. The donor then provides for all assets in excess of the Estate Tax Exempt Amount to pass at death to charity.

4. If necessary, the children (or trust) can use the insurance proceeds to purchase desirable assets (such as a family business) from the donor’s estate.

5. Because the otherwise taxable portion of the donor’s estate is passing to charity, there is no estate tax due. However, the children have still received the “full” value intended to pass to them – through the life insurance proceeds.

VI. CHARITABLE LEAD TRUSTS

A. Introduction.

1. A Charitable Lead Trust (“CLT”) is a more sophisticated tool, and not for everyone. But, a Lead Trust can be just the right thing to use in some situations.

2. Estate Tax savings is one of the primary benefits of a CLT, so it is generally a tool for those who are concerned about the Estate Tax liability. [Although there are also important non-tax reasons to create a CLT, as discussed below.]

B. What Is a CLT and How Does It Work?

1. A CLT is an irrevocable Trust that provides an “income interest” to a charity for a period of years, after which the remainder passes to the non-charity beneficiaries. It is basically the opposite of a CRT (which is briefly discussed above), and the tax consequences are significantly different.

2. The “income interest” in a CLT must be in the form of either (a) a fixed dollar amount (“Annuity Trust” or “CLAT”) or (b) a fixed percentage of the assets valued each year (“Unitrust” or “CLUT”).

3. Most often, a CLT is created at death, although it is possible to create a CLT during lifetime.

C. Tax Consequences, In General.

1. A CLT is not a tax-exempt entity. The income tax rules applicable to a CLT are the same as the rules applicable to any other irrevocable trust. However, the CLT (like other trusts) can take an income tax deduction for any amounts paid to charity each year.

2. Generally there is no income tax deduction for amounts contributed to a CLT. But if the CLT is set up to be treated as “Grantor Trust” for income tax purposes, (i) the Grantor can claim an initial income tax deduction for the present value of all the future payments to be made to charity during the Term, and (ii) all future income of the CLT is taxable to the Grantor, and no further charitable income tax deductions are allowable.

3. For capital gain tax purposes, (a) if the CLT is created at death, the assets in the trust will have a new cost basis for income tax purposes (except to the extent we continue to have “carry-over basis”); and (b) if the CLT is created during lifetime, the assets contributed to the CLT will continue with the same cost basis as in the hands of the Grantor. It is important to remember that **the sale of appreciated assets in a CLT does not avoid the capital gain tax.**

4. If the CLT is established during the Grantor’s lifetime, there will be a taxable gift on the date the CLT is created – unless the Grantor is the remainder beneficiary –

equal to the present value of the remainder interest eventually passing to the non-charitable beneficiary. [This gift does not qualify for the gift tax annual exclusion.]

5. If the Lead Trust is created at the Grantor's death, the Grantor's estate can claim a charitable estate tax deduction for the present value (at the Grantor's death) of the payments to be made to charity during the Term. With the right number of years, it is possible to "zero out" the value of the remainder interest in a CLAT, so that the remainder interest is at or close to \$0; if the payout rate is high enough and/or the Term is long enough. Although you can't reach "zero" on a CLUT, you can get fairly close.

D. Best Situations to Use a CLT.

1. When the Children have other sources of support, or other portions of the estate are being (or have been) left to the children – a CLUT can be useful for some or all of the assets eventually intended to benefit grandchildren (or children in their post-retirement years). The Estate Tax liability can be significantly reduced as a result of the CLT provisions.

2. A CLT is often a "compromise" for a donor who wants to benefit charity at death, but is not sure he/she is ready to entirely remove the assets from the family on a permanent basis. The CLT provides an opportunity to let charity "use" the assets for a period of years, yet the family still retains the eventual benefit from the assets.

3. A CLT is commonly used to benefit charity while providing for future appreciation to pass to family members, especially through the use of an Annuity Trust. The value is based on the value at the time of creation, and most of the future appreciation will generally pass to family members without additional transfer taxes.

4. A CLT can be particularly useful for assets that are already discounted for estate and gift tax purposes, such as closely-held business interests (including Limited Liability Companies or Limited Partnerships). Although the transfer tax value of the entity interest is discounted, the underlying asset value has not changed. The charitable deduction is based on the discounted value, but the underlying assets will still generate an investment return without regard to the valuation discount.

Example: Assume a CLUT is funded with family business stock which may be discounted by 25% (or more) for estate tax purposes. The "real" value of the trust assets may be \$1,000,000, but the discounted value is only \$750,000. If the payout rate is 10%, this is applied against the discounted value to require an annual payment to charity of \$75,000. When this payment is compared with the "real value" of the underlying assets in the trust (or the pro rata value of the stock), the \$75,000 annual payment will only require a 7.5% rate of return.

5. CLTs are well-suited for Generation Skipping planning where the general goal is to provide for some future benefit to family members. The donor can provide an immediate benefit to charity in the form of the CLT payments while the balance of the assets pass to descendants in the future, when the need is expected to be greatest.