

PLANNING FOR MAXIMUM TAX BENEFITS FROM LIFETIME CHARITABLE GIFTS

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A. Summary of Types of Gifts That Produce Best Tax Results

1. Lifetime Gifts

- a. In general, the greatest tax benefits from lifetime gifts come from gifts of stock and real estate that have appreciated in value ("appreciated long-term capital gain property").
- b. The reasons are economic. Whereas a gift of cash only produces one income tax benefit (a charitable deduction), a gift of appreciated stock produces two: a charitable deduction for the full fair market value of the stock plus avoidance of the capital gain tax that would have been paid had the stock been sold. Thus, as is demonstrated in below, a single charitable gift of \$10,000 of stock can reduce a person's taxable income by up to \$20,000. By comparison, the same gift to a private foundation does not receive the double benefits. The tax laws limit the income tax benefits available for charitable gifts to private foundations.
- c. Congress passed a series of laws that limit the double benefits to only a few types of assets, principally appreciated stock and real estate. As is demonstrated later, donors receive reduced tax benefits from gifts of other types of appreciated property, such as inventory and equipment ("ordinary income property") and tangible personal property (paintings, diamonds, etc.).
- d. Substantiation Rules: Even if a donor has made a completed gift to a charity, the IRS can disallow a charitable tax deduction if certain procedural requirements have not been met. Generally the donor must receive a certain type of receipt for every gift of \$250 or more and gifts of property valued at over \$5,000 (except marketable stocks and securities) must be substantiated with a qualified appraisal.

2. Charitable Bequests at Death

- a. The greatest tax benefits from testamentary gifts come from gifts of retirement plan assets. These assets produce taxable income ("income in respect of a decedent") whereas other assets have no income tax consequences to heirs. Thus, if a person is going to make a charitable bequest, it is usually better to transfer the taxable assets to a tax-exempt charity and to transfer the non-taxable assets to the heirs.
- b. **EXAMPLE WITHOUT CHARITABLE GIFT:** Uncle Richard would like his sister's two children, Denice and Denephew, to each receive \$50,000 after his death. He names Denice as a joint tenant on a \$50,000 certificate of deposit and he names Denephew as the beneficiary of his \$50,000 Individual Retirement Account ("IRA"). At his death no estate tax is due because his estate is so small. Denice will not have any taxable income when she receives the CD,¹ but Denephew will have to recognize \$50,000 of taxable income when he receives a distribution from the IRA because it is "income in respect of a decedent".² After paying income taxes, Denephew will have effectively received less than Denice.
- c. **EXAMPLE OF CHARITABLE GIFT:** Uncle Richard also would like his brother and the community foundation to each receive \$80,000 after his death. He owns \$80,000 of mutual funds and has \$80,000 in an IRA. He should give the \$80,000 of mutual funds to his brother and should give the \$80,000 in the IRA to the tax-exempt community foundation. The community foundation could then apply the entire \$80,000 to charitable purposes since it is tax-exempt, whereas his brother would have had to pay a sizeable portion of the distribution to the state and federal government to pay income taxes. His brother will not owe any income tax on the \$80,000 of mutual funds that he receives.

¹ Section 102(a).

² Sections 102(b) and 691.

B. Income Tax

1. Gifts of Appreciated Property - General Considerations

a. Tax Advantages From Appreciated "Capital Gain" Property

In general, the greatest tax benefits come from lifetime gifts of stock and real estate that have appreciated in value ("appreciated long-term capital gain property"). The reasons are economic. Whereas a gift of cash only produces one income tax benefit (a charitable deduction), a gift of appreciated stock produces two: a charitable deduction for the full fair market value of the stock plus avoidance of the capital gain tax that would have been paid had the stock been sold. This is the case even though the donor may be satisfying a legally binding pledge.³ Thus a single charitable gift of \$10,000 of stock to a public charity can reduce a person's taxable income by up to \$20,000, as is shown in the example on the next page.

By comparison, the same gift to a private foundation does not receive the double benefits. The tax laws limit the income tax benefits available for charitable gifts to private foundations.⁴ In addition, Congress passed a series of laws that limit the double benefits to only a few types of assets, principally appreciated stock and real estate. Donors receive reduced tax benefits from gifts of other types of appreciated property, such as inventory and equipment ("ordinary income property") and tangible personal property (paintings, diamonds, etc.).

b. Opposite Strategy For Gifts of Loss Property

Note that the opposite strategy applies to a gift of investment or business property (including stock or real estate) that is worth less than its adjusted basis. The donor will usually be better off selling the property and contributing the sales proceeds. This will permit the donor to recognize a tax loss which would not be deductible if the property had been given directly to the charitable organization.⁵ If the property is "personal use property", such as a personal auto or residence, there is no advantage to selling the property since the loss would not be deductible.

³ Rev. Rul. 55-410, 1955-1 C.B. 297. This is an exception to the general rule that satisfying a liability with appreciated property will cause a taxpayer to recognize a taxable gain. Helvering v. Hammel, 311 U.S. 504, 61 S.Ct. 368 (1941), Electro-Chemical v. Commissioner, 311 U.S. 513 (1941).

⁴ Section 170(e)(1)(B)(ii). There is an exception for gifts of publicly-traded stock between July 1, 1996 and May 31, 1997. Sec. 170(e)(5).

⁵ Withers v. Commissioner, 69 T.C. 900 (1978).

EXAMPLE:

Ms. Donor owns stock in a successful, closely-held family business that she purchased many years ago for virtually nothing. Now the stock is worth \$100,000 and she thinks the time is right to sell. She also wants to make a charitable contribution of \$10,000. She will either give cash of \$10,000 or will give \$10,000 of stock.

The gift of stock is the best option. Her taxable gain will be only \$90,000 instead of \$100,000 since she will only have legal title to that much stock at the time of sale. In addition, she can claim a \$10,000 charitable deduction for the value of the stock that she gave to the charity. By comparison, if she gave the stock to a private foundation she would only be able to claim a charitable deduction for the cost of the stock, rather than the value.

FACTS: Fair Market Value of Stock: \$100,000
 Cost of Stock (near zero): \$ -0-
 PC: Public Charity (a public charity)
 PF: Private Foundation (a private foundation)

	<u>Gift of Cash To PC or PF</u>	<u>Gift of Stock to PC</u>	<u>Gift of Stock to PF</u>
Sales Proceeds	\$ 100,000	\$ 90,000	\$ 90,000
Cost of Stock	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Gain on Sale	\$ 100,000	\$ 90,000	\$ 90,000
Charitable Deduction	<u>(10,000)</u>	<u>(10,000)</u>	<u>-0- *</u>
Taxable Income after sale and charitable gift	\$ 90,000 ■	\$ 80,000 	\$ 90,000

* A contributor of appreciated closely-held stock to a private foundation can only deduct the stock's cost rather than the higher market value. Even though Congress permits market-value deductions for gifts of appreciated *publicly-traded* stock to private foundations (Sec. 170(e)(5), which Congress made permanent in 1998 tax legislation), there are no plans to extend the market value deduction to gifts of *closely-held* stock.

c. Property in the Process of Being Sold.

As was demonstrated in the example on the preceding page, one of the most important aspects of a charitable contribution of appreciated long-term capital gain property is the ability to avoid paying the capital gain tax that would be incurred had the property been sold. The tax savings loom heavily on a donor's mind if a sale is imminent. It is, therefore, very common for a charity to be approached by a donor (or for the charity to approach a donor) who is in the process of selling a closely-held business or a large parcel of real estate. The sale will usually produce a large amount of income and a large charitable contribution deduction could produce the greatest benefit in the year of sale. Furthermore, the low-yielding property will soon be converted to cash that can be invested in higher yielding assets.

From the donor's perspective, one of the dangers of contributing property that is in the process of being sold is that the IRS could examine the transaction and conclude that the donor had, in substance, already sold the property and was merely assigning the proceeds of the sale to the charitable organization. In that case, the donor would pay the capital gain tax on the transaction and would only receive a deduction for a charitable contribution of cash.⁶ The donor must be careful to make the contribution before the sales transaction has been substantially completed in order to avoid such a result.

d. Stock Redemptions

Another very common situation is that a shareholder may contribute stock of a closely-held corporation to a public charity and the corporation will later redeem the stock for cash. An attractive candidate is a corporation with a large cash accumulation that is concerned about being assessed with the accumulated earnings tax.⁷ After the redemption, the corporation has less cash (and is therefore less likely to be subject to the accumulated earnings tax) and the shareholder and his family (rather than the corporation) enjoy the benefits of an advised fund.

⁶ Horace E. Allen v. Commissioner, 66 T.C. 340 (1976) and Jones v. U.S., 531 F.2d 1343 (6th Cir. 1976). Compare Johnson v. Commissioner, 63 T.C. 778 (1975) where the taxpayer was victorious.

⁷ The accumulated earnings tax is imposed during IRS audits on corporations that accumulate cash beyond the corporation's reasonable needs. Sections 531-537. The tax is designed to force closely-held corporations to declare dividends to their shareholders unless the accumulation had a legitimate corporate purpose.

However, if the charity is compelled to sell the stock, the IRS could raise the same argument that the shareholder has merely assigned the proceeds from a prearranged sale and should be taxed as if the stock had been sold or as if a dividend had been distributed to the shareholder.

The IRS announced in Rev. Rul. 78-197 that it will treat the proceeds of a redemption of stock as income to the donor only if the charitable organization is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.⁸

2. Gifts of Appreciated Property - Technical Rules

Congress enacted several provisions as part of The Tax Reform Act of 1969 to respond to several abuses and to curtail tax benefits from gifts of certain forms of appreciated property. At that time it was possible to be wealthier by contributing appreciated property to a charitable organization than to sell the property and keep the cash (particularly if the property was "ordinary income property", described below).

a. Gifts of Ordinary Income Property Limited To Basis

Whereas a taxpayer can normally claim a tax deduction equal to the fair market value of the contributed property, the deduction for gifts of "ordinary income property" must be reduced by the amount of gain that would have been realized had the property been sold.⁹ The net effect is that the tax deduction is usually limited to the taxpayer's "basis" in the property (usually its cost).

⁸ Rev. Rul. 78-197, 1978-1 C.B. 83. IRS has also approved similar transactions through letter rulings issued to donors who contemplated gifts of stock followed by redemptions. See, for example, Private Letter Rulings 9452020 (Sep. 30, 1994), 8810009 (Sep. 25, 1987), 8701029 (Oct. 7, 1986) and (for a situation that involved a community foundation) 8532027 (May 10, 1985). An interesting situation where the IRS explicitly acknowledged that stock would likely be redeemed was where donors contributed stock of a "statutory close" corporation to a private foundation and the private foundation immediately distributed the stock to a public charity to satisfy the private foundation's pledge. Private Letter Ruling 9611047 (Dec. 15, 1995).

Section 170(e)(1)(A); Treas. Reg. Section 1.170A-4(a).

Ordinary income property is property that, if sold at its fair market value, would result in a gain other than a long-term capital gain.¹⁰ Thus, ordinary income property includes a capital asset (such as stock) that has not been held by the donor for more than one year because the gain on its sale would be a short-term capital gain.¹¹ It also includes the portion of gain on a sale of property, such as rental property, that is treated as ordinary income under the "depreciation recapture" rules.¹²

For example, assume a business contributes to a charity inventory that has a value of \$10 but was purchased for \$6. The \$10 tax deduction is reduced by the amount of ordinary income that would have been recognized had the property been sold (\$4) so that the net deduction is limited to the taxpayer's basis in the property (\$6).¹³

There are two exceptions that permit a corporation to deduct more than its basis.¹⁴

¹⁰ Section 170(e)(1)(A), Treas. Reg. Section 1.170A-4(b)(1). Examples of ordinary income property include inventory, a work of art created by the donor, a manuscript prepared by the donor, and letters or memoranda prepared by or for the donor. Treas. Reg. Section 1.170A-4(b)(1). Also included is certain stock to the extent that gain on its disposition would not have been long-term capital gain. Such stock is described in Sections 306(a) (Section 306 stock - usually preferred stock issued in a recapitalization), 341(a) (collapsible corporations), or 1248(a) (stock of certain foreign corporations).

¹¹ Section 1222(1).

¹² Ordinary income property includes the portion of any gain from the disposition of depreciable or other property that, if sold, would be treated as ordinary income under the depreciation recapture rules of Sections 1245, 1250, 617(d) or 1252. Generally this includes all depreciation recapture for personal property used for business or investment purposes, such as equipment, cars and computers. However, real property generally qualifies for favorable capital gain treatment for some or all depreciation recapture.

¹³ There is, however, no reduction if ordinary income is in fact recognized by the donor because of the transfer. For example, if a dealer's contribution of an installment obligation will cause the deferred income to be recognized under Section 453B, the full value of the obligation will be deductible. Treas. Reg. Section 1.170A-4(a).

¹⁴ The first applies to contributions of inventory to care for the ill, needy or infants. Section 170(e)(3) and Treas. Reg. Section 1.170A-4(a) permit a Subchapter C corporation to claim a greater deduction for contributions of stock in trade or depreciable property used in its trade or business that is contributed to a Section 501(c)(3) charitable organization (other than a private non-operating foundation) and is used solely for the care of the ill, the needy or infants. Unlike gifts of other forms of property, no appraisals are required from corporations that contribute more than \$5,000 of such inventory in a year. IRS Notice 89-56, 1989-21 I.R.B. 23. There are,

b. Long-Term Capital Gain Property

i. In General

Unlike gifts of ordinary income property, a donor can usually deduct the entire fair market value of long-term capital gain property. Thus, donors have a greater incentive to contribute such property to a charitable organization than other forms of property. Wealthy investors have frequently favored investments that produce long-term capital gains since such gains are taxed at a lower rate than other income, such as interest and dividends.¹⁵ The additional advantage from charitable contributions make these assets even more attractive.

All appreciated capital¹⁶ and Section 1231 assets held for more than 12 months meet the definition of "long-term capital gain property", except for the portion of any gain that constitutes ordinary income. Such ordinary income usually arises from depreciation

of course, special rules and limitations. For example, property must comply with the Federal Food, Drug and Cosmetic Act (if applicable) and any gain which would have been attributable to depreciation recapture had the asset been sold is not eligible for the increased deduction.

The second applies to contributions of certain scientific equipment. Section 170(e)(4) permits corporate manufacturers of scientific equipment to claim a greater deduction for "qualified research contributions" of such equipment to educational institutions or other Section 501(c)(3) organizations (other than private foundations) that use it for research and experimentation.

In either case, the deduction is generally the basis of the property plus one-half of the unrealized appreciation, with a maximum deduction of twice the basis. Sections 170(e)(3)(B) and 170(e)(4)(1).

¹⁵ In 1996, individuals paid a maximum tax rate of 28% on long-term capital gains compared to a maximum rate of 39.6% on other income. Section 1.

¹⁶ Section 1221 defines capital assets in the negative. Thus, every asset is a capital asset except for:

- (1) stock in trade (inventory),
- (2) land or depreciable property used in a trade or business (usually this is referred to as Section 1231 property, which, if sold for a gain qualifies for the charitable deduction as long-term capital gain property),
- (3) a copyright or self-created work of art or letter,
- (4) accounts or notes receivable received in the ordinary course of business, and
- (5) free U.S. government publications.

Thus virtually every nonbusiness assets is a capital asset (e.g., personal car, personal residence), but because of other restrictions governing gifts of tangible personal property the best tax consequences are associated with gifts of real property (land and buildings) and intangible personal property (usually stock of a corporation).

recapture for business equipment and buildings¹⁷ and from certain types of closely-held stock.¹⁸ Thus, for example, a donor who contributes a building or rental property will usually be unable to deduct the full appraised value of the property since the deduction must be reduced by the amount of depreciation recapture from the equipment and furniture that is treated as ordinary income.¹⁹

¹⁷ Section 1245 triggers the most depreciation recapture, followed by Section 1250 (certain real property). Corporations are subject to special depreciation recapture under Section 291, which converts into ordinary income 20% of the amount of depreciation recapture that would have been treated as long-term capital gain. Other recapture rules are in Section 617(d) (mining property subject to exploration expenditures) and 1252 (farm land subject to soil and water conservation expenditures). Please see the example concerning rental property in the second subsequent footnote.

¹⁸ The stock subject to ordinary income rules include:

- Section 306 stock - Typically preferred stock that a donor received in a corporate reorganization. See Bialo v. Commissioner, 88 T.C. 1132 (1987) for a case involving a gift of Section 306 stock to a community foundation.
- Section 341(a) stock - Certain stock of a collapsible corporation.
- Section 1248(a) stock - Stock of certain foreign corporations.

¹⁹ For example, assume that a donor acquired rental property ten years ago and claimed straight line depreciation on the building and equipment. The property currently has the following tax basis and appraised values (all numbers are in thousands):

	<u>TAX BASIS</u>			<u>APPRAISED</u>	<u>GAIN</u>
	<u>Original</u>		<u>Tax</u>	<u>VALUE</u>	<u>IF SOLD</u>
	<u>Cost</u>	<u>Depreciation</u>	<u>Basis</u>		
Land	70	-0-	70	141	71
Building	120	(40)	80	150	70
Equipment	<u>10</u>	<u>(8)</u>	<u>2</u>	<u>9</u>	<u>7</u>
Total	\$200	\$(48)	\$152	\$300	\$148

The donor's tax deduction would be \$293,000 (\$300,000 market value reduced by the \$7,000 of depreciation recapture that would have been treated as ordinary income if the property had been sold). Under Section 1245, the depreciation recapture for personal property is treated as ordinary income. However, for real property, such as a building, Section 1250 provides that only the excess of accelerated depreciation deductions over straight line deductions is treated as ordinary income. Since this taxpayer used the straight-line method for the real property, none of the \$40,000 of depreciation deductions that would have been recaptured upon a sale would be treated as ordinary income; it would all be long-term capital gain.

If the donor is a corporation, however, the deduction would be reduced by an

Despite the many assets that meet the tax definition of a capital asset, usually the best tax consequences arise only from charitable contributions of real property (land and buildings) and intangible personal property (usually stock of a corporation). Congress imposed significant restrictions on most gifts of tangible personal property (such as automobiles and paintings) which limit their attractiveness as assets to contribute to a charity.

ii. Gifts of Tangible Capital Gain Property Usually Limited To Basis

Tangible capital gain property includes paintings, books, and personal autos but does not include intangible property such as stocks. In most cases, the deduction for gifts of such appreciated property will be limited to the donor's adjusted basis (usually the property's cost).²⁰ If, however, the charitable organization uses the property for its exempt purpose, then the donor can deduct the full fair market value.²¹

additional \$8,000 (20% times \$40,000). Section 291 provides that 20% of depreciation recapture that would normally qualify as long-term capital gain will be classified as ordinary income to a corporation.

²⁰ Section 170(e)(1)(B)(I).

Treas. Reg. Section 1.170A-4(b)(3)(ii) provides that a donor may treat the gift as being put to a related use if:

(a) He establishes that the property is not in fact put to an unrelated use by the donee, or

(b) At the time of the contribution or at the time the contribution is treated as made, it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. In the case of a contribution of tangible personal property to or for the use of a museum, if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable

for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee.

²¹ The classic example is a painting: if in 1990 a donor contributed a painting to a college that used it for educational purposes by placing it in its library for display and study by art students, then the use was not an unrelated use. Thus, if the donor had purchased the painting for \$30,000 but its value was \$100,000 at the time of contribution, the donor could deduct the full \$100,000. However, if the college sold the painting and used the proceeds for educational purposes, the painting was used for an unrelated purpose and the donor's tax deduction would be limited to \$30,000. Treas. Reg. Sec. 1.170A-4(b)(3)(ii) (after adjusting for new rules under the 1986 Tax Reform Act).

iii. Gifts of Capital Gain Property to A Private Non-operating Foundation Usually Limited To Basis.

A similar rule that limits the tax deduction to an asset's adjusted basis for gifts of most forms of appreciated capital gain property to a private non-operating foundation.²² The one exception applies to gifts of appreciated publicly traded stock: between July 1, 1996 and May 31, 1997, the entire fair market value of such stock may be deducted.²³ Public charities benefit from this harsh treatment of gifts to private non-operating foundations because it encourages gifts of land and non-traded stock to them instead of private foundations. Donors can deduct the full fair market value of such property contributed to a public charity whereas they can only deduct its cost if it is given to a private non-operating foundation.

Another exception is that a grant to a private operating foundation receives the same tax benefits as a contribution to a public charity.²⁴ A private operating foundation is a private foundation that devotes more than half of its assets directly to, and substantially all of its income is expended directly for, the active conduct of its charitable purposes.²⁵ Examples include the Carnegie Foundation for the Advancement of Teaching and the Getty Museum.

c. Alternative Minimum Tax and Charitable Gifts

Between 1986 and 1993, the tax benefits from charitable gifts of long-term capital gain property were significantly reduced if the taxpayer was subject to the alternative minimum tax ("AMT"). The net affect was that such a taxpayer could only claim a charitable tax deduction for the cost for the property, rather than its higher market value.²⁶ This provision of the law was repealed in 1993.

²² Section 170(e)(1)(B)(ii).

²³ Section 170(e)(5). The exception only applies to stock held for the long-term capital gain holding period and for which market quotations as of the date of contribution are readily available on an established securities market

²⁴ Sections 170(b)(1)(A)(vii), 170(b)(1)(E)(I) and 4942(j)(3).

²⁵ Section 4942(j)(3).

²⁶ The law at that time treated as a "tax preference" the excess of the value of the capital gain property over its adjusted tax basis. Section 57(a)(6)(1986), as explained in H.R. Rep. No. 426, 99th Cong., 1st Sess., at 305-6 (1986). Capital gain property was defined in the same manner as it was for regular tax purposes. Sections 57(a)(6)(B) and 170(b)(1)(C)(iv).

3. Annual Deduction Limitations

a. In General

The maximum amount that can be deducted in any given year is based on a donor's income. Gifts to public charities generally qualify for better income tax treatment than comparable gifts to private foundations.

b. Individuals

The amount of the deduction depends on (1) the type of property contributed (either ordinary income or long-term capital gain property), (2) the nature of the charitable organization, and (3) the amount of adjusted gross income ("AGI") shown on the donor's Form 1040. The rules generally are:

<u>Type of Charity</u>	<u>Cash and Ord Inc Prop</u> ²⁷	<u>Capital Gain Property (Stock & Real Estate)</u> ²⁸
Public Charity ²⁹	50% of AGI	30% of AGI
Private Non-Operating Foundation ³⁰	30% of AGI	20% of AGI
Private Operating Foundation ³¹	50% of AGI	30% of AGI

²⁷ Ordinary income property is defined as property which, if sold, would result in a gain other than a long-term capital gain (i.e., inventory or capital assets held for less than one year). Sections 170(e)(1)(A) and 1222(1).

²⁸ The tax code defines "capital gain property" as any capital asset or Section 1231 asset which, if sold at its fair market value, would result in a long-term capital gain (i.e., held for more than one year). Sections 170(b)(1)(C)(iv) and 1222(3).

²⁹ Sections 170(b)(1)(A) and © and Treas. Reg. Section 1.170A-9(e)(11)(ii).

³⁰ Sections 170(b)(1)(B) and 170(b)(1)(D).

³¹ Sections 170(b)(1)(A)(vii) and 170(b)(1)(E).

Amounts that cannot be deducted may be carried forward for five years.³² If they are not deducted within that time, the benefits expire.

An individual may elect to use the higher 50% limit for a gift of capital gain property to a public charity if the donor elects to deduct the adjusted basis of the property rather than its market value.³³ Such an election can be advantageous if there is minimal appreciation. For example, an individual who intends to contribute an inherited asset to a charity should probably make the election because there would be very little appreciation after the beneficiary takes the "stepped-up" basis of the value shown on the estate tax return.³⁴

C. Tax Advantages That Deferred Giving Arrangements Provide To Donors

In recent years many estate and financial planners have focused on some of the non-charitable benefits that donors can obtain from deferred giving arrangements. There has been a significant growth in the number of financial institutions that have actively promoted planned gifts since 1991. Attention is principally paid to charitable remainder trusts since they are tax-exempt and the donor can have a greater voice on how the trust's assets will be invested.

Some of the benefits that estate and financial planners have cited to promote deferred charitable gifts include the following:

1. A donor can claim an immediate tax deduction for a gift that a charity will not receive for many years. If a donor was going to make a bequest to a charity, the donor could instead contribute the property to a deferred giving arrangement and claim a current income tax deduction even though the donor will retain much of the income generated by the property over the rest of the donor's life. For lifetime ("inter vivos") gifts, see Sections 170(f)(2)(A) (income tax) and 2522(c)(2)(A)(gift tax). Similar benefits accrue to an estate for a gift made at death (a "testamentary" gift). For example, a donor's will can state that a specified amount of property will be contributed to a deferred giving arrangement that will pay income to a sibling and will pay the remainder to a charity. The estate can claim an immediate estate tax deduction even though the charity will not receive the property for many years.

³² Section 170(b)(1)(C)(ii), Section 170(b)(1)(D)(ii), and last sentence of Section 170(b)(1)(B).

³³ Section 170(b)(1)(C)(iii).

³⁴ Section 1014(a)(1).

2. A deferred giving arrangement permits the tax-free conversion of appreciated low-yield growth assets into high-yield income-producing assets, which can be beneficial either at retirement or shortly before a major asset is about to be sold. Under the typical scenario, a donor has appreciated stock or real estate that is in the process of being sold. Normally a sale causes the donor to pay a capital gains tax, so that less will be available to reinvest in income-producing assets. An alternative is to give the property to a deferred giving arrangement and claim an income tax charitable deduction for the present value of the remainder interest. A charitable remainder trust (or in the case of a charitable gift annuity, the charity) can then sell the property free of any income tax because it is a tax-exempt trust under Section 664(c). A pooled income fund also pays no tax on the gain even though it is *not* a tax-exempt trust. Thus, all of the sales proceeds can be reinvested in high-yield investments. Of course, it is important that the property be contributed to the deferred giving arrangement before the terms of the sale are finalized. See Rev. Rul. 78-197, 1978-1 C.B. 83.
3. A "wealth-replacement" plan permits the tax-free conversion of the donor's investments and permits both the heirs and the charity to inherit substantial amounts. Often the heirs complain that a gift to a deferred giving arrangement will mean that they will inherit less. One solution is a "wealth replacement" plan.

This is where the donor gives appreciated property to the deferred giving arrangement, just as was done in the preceding footnote. The donor also uses the tax refund from the income tax charitable deduction to contribute amounts to a "life-insurance trust" that will purchase a single-premium life insurance policy on the donor's life (or, more frequently, a "last-to-die" policy for the donor and the donor's spouse). The life insurance trust usually names the children or grandchildren as beneficiaries. Through these transactions, the heirs can eventually receive the same amount that they would have received if they had inherited the appreciated property, while at the same time the charity will receive the remainder interest. See "Fund-Raising Execs Extol Virtues, Warn Of Pitfalls Of Remainder Trusts," 94 *Tax Notes Today* 215-6 (Nov. 2, 1994).

EXAMPLE:

Mr. Husband and Ms. Wife, both age 65, are about to sell a business for \$10,000,000 that they began many years ago on a shoestring budget. They are contemplating a contribution of \$1,000,000 of stock to a 7% charitable remainder trust before the sales negotiations are completed. Assuming that interest rates are 7%, they will have approximately 25% more annual income if they contribute the stock to a tax-exempt charitable remainder trust than if they retain the stock. In addition, they will be entitled to an income tax charitable deduction of approximately \$250,000, which will produce a tax refund that they can use for themselves or to benefit their heirs.

	<u>KEEP THE STOCK</u>	<u>CONTRIBUTE STOCK TO C.R.T.; C.R.T. SELLS STOCK</u>
Sales Price	\$ 1,000,000	\$1,000,000
Cost of Stock	<u> -0-</u>	<u> -0-</u>
Gain on Sale	\$ 1,000,000	\$1,000,000
Capital Gains Tax (about 15%)	<u> 150,000</u>	<u> None</u>
Remaining Proceeds	\$ 850,000	\$1,000,000
Interest Rate	<u> x 7%</u>	<u> x 7%</u>
Annual Income	\$ 59,500 ▄▄▄	\$ 70,000 ▄▄▄
		(18% more)

NOTABLE CHANGES MADE BY THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

I. ESTATE AND GIFT TAX CHANGES

The Act significantly increases the amount that a person can have at death without being subject to estate tax and it gradually reduces the highest marginal tax rate. The estate tax is completely repealed only in the year 2010 before it reappears in the year 2011 under the basic rules that existed in the year 2001. This Congress has obviously left it up to future Congresses to adjust the schedule for the repeal of the estate tax. Unless a future Congress makes changes, this Congress has introduced a ridiculous financial incentive for people to have an early death. Paradoxically, the gift tax remains unchanged for the entire period.

The thresholds are summarized in the table below (changes are highlighted in bold):

Year	Lifetime Gift Tax Threshold	Estate Tax Exemption Amount	Highest Estate & Gift Tax Rate
2001	\$675,000	\$675,000	55% (+5% surtax)
2002	\$1 million	\$1 million	50%
2003	\$1 million	\$1 million	49%
2004	\$1 million	\$1.5 million	48%
2005	\$1 million	\$1.5 million	47%
2006	\$1 million	\$2 million	46%
2007	\$1 million	\$2 million	45%
2008	\$1 million	\$2 million	45%
2009	\$1 million	\$3.5 million	45%
2010	\$1 million	Repealed !	Max gift tax rate = max inc tax rate
2011	\$1 million	Reinstate: \$1 million	55% (+5% surtax)

* The generation skipping tax thresholds will equal the estate tax thresholds in all years except for 2001, 2002, 2003 and 2011, when the amount will equal \$1,060,000 indexed for inflation.

Carryover Income Tax Basis in the Year 2010: The year that the estate tax is repealed (i.e., only in the year 2010) the law repeals the general income tax rule of “step-up basis”. Under current step-up basis rules, the income tax basis to the heirs of inherited property is equal to either (1) the value at the time of the decedent’s death or (2) the “alternate valuation date” of six months after the date of death. Usually this is higher than the purchase price that the decedent paid for the assets, ergo the term “step-up basis”. Instead, in the year 2010 the step-up basis will be limited to \$1.3 million of assets in the estate (\$3 million for assets that pass to a surviving spouse) and the remaining assets will have the same income tax basis to the beneficiaries that the decedent had (“carryover basis”).

INTRODUCTION: Types of Gifts That Produce Best Tax Results

A. Lifetime Gifts

1. In general, the greatest tax benefits from lifetime gifts come from gifts of stock and real estate that have appreciated in value ("appreciated long-term capital gain property").
2. The reasons are economic. Whereas a gift of cash only produces one income tax benefit (a charitable deduction), a gift of appreciated stock produces two: a charitable deduction for the full fair market value of the stock plus avoidance of the capital gain tax that would have been paid had the stock been sold. Thus, as is demonstrated in below, a single charitable gift of \$10,000 of stock can reduce a person's taxable income by up to \$20,000. By comparison, the same gift to a private foundation does not receive the double benefits. The tax laws limit the income tax benefits available for charitable gifts to private foundations.
3. Congress passed a series of laws that limit the double benefits to only a few types of assets, principally appreciated stock and real estate. Donors receive reduced tax benefits from gifts of other types of appreciated property, such as inventory and equipment ("ordinary income property") and tangible personal property (paintings, diamonds, etc.).

B. Charitable Bequests at Death

1. The greatest tax benefits from testamentary bequests come from assets that produce taxable income ("income in respect of a decedent") to the estate or beneficiary. Normally an inheritance does not trigger taxable income to the estate or to heirs. Thus, if a person is going to make a charitable bequest, it is usually better to transfer the taxable assets to a tax-exempt charity and to transfer the non-taxable assets to the heirs.
2. **EXAMPLE:** Uncle Richard would like his brother and the community foundation to each receive \$80,000 after his death. He owns \$80,000 of mutual funds and has \$80,000 in an IRA. He should give the \$80,000 of mutual funds to his brother and should give the \$80,000 in the IRA to the tax-exempt community foundation. The community foundation could then apply the entire \$80,000 to charitable purposes since it is tax-exempt, whereas his brother would have had to pay a sizeable portion of the distribution to the state and federal government to pay income taxes. His brother will not owe any income tax on the \$80,000 of mutual funds that he receives. Sec. 102(a).

**FEDERAL ESTATE TAX RETURNS
RETIREMENT PLAN ASSETS AND ANNUITIES; CHARITABLE DEDUCTIONS**

Year	TOTALS		RETIREMENT PLANS/ANNUITIES			CHARITABLE		
	# of Returns	Value (millions)	Gross Returns	# of Returns	Value (millions)	# of Returns	Value (millions)	% Returns
2000	108,322	\$217,402	56,921	53	\$17,410	8.0	18,011	17
1997	90,006	\$162,251	41,788	46	\$10,116	6.2	15,575	17
1995	69,772	\$117,735	30,938	44	\$6,632	5.6	13,063	19
1992	59,176	\$98,850	22,738	38	\$4,095	4.1	11,053	19
1989	45,695	\$77,997	14,223	31	\$2,309	3.0	8,471	19
1986	45,125	\$59,805	11,244	25	\$1,350	2.3	7,835	17

SOURCE: IRS Statistics of Income Bulletins for the applicable years.
See web <http://www.irs.ustreas.gov/prod/tax_stats/estate.html>

Estate Tax Returns Filed in 2000: Estate Size and Charitable Deductions

[All figures are estimates based on samples--money amounts are in thousands of dollars]

Size of gross estate	Gross estate		Charitable deduction				Average Charit (thousands of dollars)
	Number of returns	Amount (in thousand \$)	Number	%	Amount (in thousand \$)	Percent of estate	
All returns	108,322	217,402,426	18,011	17%	16,092,353	7%	
\$600,000 under \$1,000,000	47,845	38,598,125	5,820	12%	893,845	2%	154
\$1,000,000 under \$2,500,000	45,248	66,946,098	8,144	18%	2,559,023	4%	314
\$2,500,000 under \$5,000,000	10,018	34,085,398	2,232	22%	2,092,929	6%	938
\$5,000,000 under \$10,000,000	3,386	23,286,561	1,062	31%	1,989,358	9%	1,873
\$10,000,000 under \$20,000,000	1,129	15,253,132	432	38%	1,522,228	10%	3,524
\$20,000,000 or more	696	39,233,112	321	46%	7,034,969	18%	21,916
Taxable returns	52,000	130,371,309	10,959	21%	9,803,010	8%	
\$600,000 under \$1,000,000	18,634	15,800,654	2,420	13%	49,246	0%	20
\$1,000,000 under \$2,500,000	23,827	35,518,751	5,550	23%	710,046	2%	128
\$2,500,000 under \$5,000,000	5,917	20,265,359	1,541	26%	765,493	4%	497
\$5,000,000 under \$10,000,000	2,258	15,545,769	812	36%	911,994	6%	1,123
\$10,000,000 under \$20,000,000	814	11,032,374	347	43%	944,182	9%	2,721
\$20,000,000 or more	549	32,208,403	288	52%	6,422,049	20%	22,299
Nontaxable returns	56,322	87,031,116	7,053	13%	6,289,343	7%	

\$600,000 under \$1,000,000	29,211	22,797,471	3,401	12%	844,599	4%	248
\$1,000,000 under \$2,500,000	21,421	31,427,347	2,593	12%	1,848,977	6%	713
\$2,500,000 under \$5,000,000	4,100	13,820,039	691	17%	1,327,436	10%	1,921
\$5,000,000 under \$10,000,000	1,128	7,740,793	250	22%	1,077,364	14%	4,309
\$10,000,000 under \$20,000,000	315	4,220,758	85	27%	578,046	14%	6,801
\$20,000,000 or more	147	7,024,709	33	22%	612,920	9%	18,573

"Taxable Returns" means that estate tax was due. "Nontaxable returns" were filed by estates that had over \$675,000 of assets but where no estate tax was due. Typically these were estates of a "first spouse to die" where the estate claimed a "marital deduction" for the portion that would transfer to the surviving spouse. Some estates owed no tax because everything was left to charity.

For this and other IRS statistics, see the IRS web cite <http://www.irs.ustreas.gov/prod/tax_stats/estate.html>

Estate Tax Returns Filed in 2000: Retirement Plans, IRAs and Annuities

[All figures are estimates based on samples--money amounts are in thousands of dollars]

Size of gross estate	Gross estate		Retirement Plans, IRAs & Annuities				Average Amount (thousands of dollars)
	Number of returns	Amount (in thousand \$)	Number	%	Amount (in thousand \$)	Percent of estate	
All returns	108,322	217,402,426	56,921	53%	17,410,160	8%	
\$600,000 under \$1,000,000	47,845	38,598,125	23,537	49%	4,236,045	11%	180
\$1,000,000 under \$2,500,000	45,248	66,946,098	25,579	57%	7,808,143	12%	305
\$2,500,000 under \$5,000,000	10,018	34,085,398	5,294	53%	3,272,914	10%	618
\$5,000,000 under \$10,000,000	3,386	23,286,561	1,649	49%	1,124,415	5%	682
\$10,000,000 under \$20,000,000	1,129	15,253,132	544	48%	594,709	4%	1,093
\$20,000,000 or more	696	39,233,112	320	46%	373,934	1%	1,169
Taxable returns	52,000	130,371,309	23,127	44%	6,826,249	5%	
\$600,000 under \$1,000,000	18,634	15,800,654	8,006	43%	1,436,579	9%	179
\$1,000,000 under \$2,500,000	23,827	35,518,751	11,057	46%	3,004,736	8%	272
\$2,500,000 under \$5,000,000	5,917	20,265,359	2,516	43%	1,228,174	6%	488
\$5,000,000 under \$10,000,000	2,258	15,545,769	983	44%	550,991	4%	561
\$10,000,000 under \$20,000,000	814	11,032,374	335	41%	313,057	3%	934
\$20,000,000 or more	549	32,208,403	229	42%	292,711	1%	1,278
Nontaxable returns	56,322	87,031,116	33,794	60%	10,583,911	12%	
\$600,000 under \$1,000,000	29,211	22,797,471	15,531	53%	2,799,466	12%	180
\$1,000,000 under \$2,500,000	21,421	31,427,347	14,521	68%	4,803,406	15%	331
\$2,500,000 under \$5,000,000	4,100	13,820,039	2,777	68%	2,044,740	15%	736
\$5,000,000 under \$10,000,000	1,128	7,740,793	665	59%	573,425	7%	862
\$10,000,000 under \$20,000,000	315	4,220,758	209	66%	281,652	7%	1,348
\$20,000,000 or more	147	7,024,709	91	62%	81,222	1%	893

("Taxable Returns" and "Nontaxable returns" are explained on the previous page.)

For this and other IRS statistics, see the IRS web site

<http://www.irs.gov/pub/irs-soi/00/estret.html>

Estate Tax Returns Filed in 1998: Retirement Plans, IRAs and Annuities -- Variations Based on Age and Gender

(A) Percent of Returns that Report Any Retirement Plan Assets and

(B) Percent of All Assets that are in Retirement Plan Accounts

	MALE		FEMALE	
	% of returns with retirement assets	% of all assets	% of returns with retirement assets	% of all assets
ALL 1998 RETURNS	55,495	112,434 (\$ millions)	48,487	83,190 (\$ millions)
% OF ALL RETURNS REPORTING RETIREMENT ACCOUNTS	47%	6%	31%	3%
Under age 50	63%	7%	64%	6%
Ages 50 to 65	69%	12%	62%	8%
Over age 65	43%	5%	28%	3%

Source: Barry Johnson and Jacob Mikow, "Federal Estate Tax Returns, 1998-2000," Figures F and G, IRS Statistics of Information Bulletin, available at

D.1 COMBINATION OF ESTATE AND INCOME TAXES ON INCOME IN RESPECT OF A DECEDENT -- Year 2003.

EXAMPLE: Assume that Mother's total taxable estate is \$3,200,000 and that all of it will be transferred to her sole heir: Daughter. Assume that the probate estate will pay the entire estate tax regardless of how her daughter acquired the assets (e.g., joint tenancy, etc.). If \$100,000 in an IRA is immediately distributed to Daughter and if Daughter is in a 35% marginal income tax bracket, then the combined estate and income taxes on the \$100,000 of IRA assets would be **\$68,530 (68.5%)**. The amount is calculated as follows:

Beginning Balance in Retirement Plan		\$ 100,000
Minus: Total Estate Tax Paid by the Probate Estate (49% bracket)		(49,000)
<u>Minus: Income Tax On Distribution</u>		
Gross Taxable Income	\$ 100,000	
Reduced By §691(c) Deduction for Federal Estate Tax		
Total Estate Tax	\$ 49,000	
State Tax Credit (½)*	(4,800)	
Deduction for <i>Federal</i> Estate Tax **	<u>(45,200)</u>	
Net Taxable Income ***	\$ 55,800	
Times Income Tax Rate	<u>x 35%</u>	
Net Income Tax on Income In Respect Of Decedent		<u>(19,530)</u>
NET AFTER-TAX AMOUNT TO DAUGHTER		\$ 31,470

* The deduction for estate tax attributable to income in respect of a decedent is only for the *federal* estate tax; the Section 2011 state tax credit (9.6% for an estate over \$3,100,000) has therefor been eliminated. Treas. Reg. Section 1.691(c)-1(a). The state tax credit is being phased out; only 50% qualifies in 2003.

** The deduction is an itemized deduction on Schedule A that is claimed on the last line of the form ("other miscellaneous deductions"). It is not subject to the 2%-of-adjusted-gross-income ("AGI") limitation that most miscellaneous deductions are subject to. Sec. 67(b)(7).

*** The net taxable income from the IRD will actually be greater than this amount. The IRD will increase the recipient's AGI by \$100,000 which will decrease the recipient's itemized deductions by 3%, which would be \$3,000 in this example. Sec. 68. The 3% reduction was omitted from this calculation in order to simplify the computation.

D.2 COMBINATION OF FEDERAL ESTATE AND INCOME TAXES ON INCOME IN RESPECT OF A DECEDENT -- (Years 2007 through 2009). State estate and income taxes are extra!

EXAMPLE: Assume that Mother's total taxable estate is \$4,000,000 and that all of it will be transferred to her sole heir: Daughter. Assume that the probate estate will pay the entire estate tax regardless of how her daughter acquired the assets (e.g., joint tenancy, etc.). If \$100,000 in an IRA is immediately distributed to Daughter and if Daughter is in a 35% marginal income tax bracket, then the combined estate and income taxes on the \$100,000 of IRA assets would be **\$64,250 (64.25%)**. The amount is calculated:

Beginning Balance in Retirement Plan		\$ 100,000
Minus: Total Estate Tax Paid by the Probate Estate		(45,000)
<u>Minus: Income Tax On Distribution</u>		
Gross Taxable Income	\$ 100,000	
Reduced By §691(c) Deduction for Federal Estate Tax		
Total Estate Tax	\$ 45,000	
State Tax Credit*	<u>Zero</u>	
Deduction for Federal Estate Tax **	<u>(45,000)</u>	
Net Taxable Income ***	\$ 55,000	
Times Income Tax Rate	<u>x 35.0%</u>	
Net Income Tax on Income In Respect Of Decedent		<u>(19,250)</u>
NET AFTER-TAX AMOUNT TO DAUGHTER		\$ 35,750

* Treas. Reg. Section 1.691(c)-1(a) limits the deduction to *federal* estate tax. The 2001 Tax Act provides that the Section 2011 state tax credit will be fully repealed by the year 2007 so there is no state tax adjustment.

** The deduction is an itemized deduction on Schedule A that is claimed on the last line of the form ("other miscellaneous deductions"). It is not subject to the 2%-of-adjusted-gross-income ("AGI") limitation that most miscellaneous deductions are subject to. Sec. 67(b)(7).

*** The net taxable income from the IRD will actually be greater than this amount. The IRD will increase the recipient's AGI by \$100,000 which will decrease the recipient's itemized deductions by 3%, which would be \$3,000 in this example. Sec. 68. The 3% reduction was omitted from this calculation in order to simplify the computation.