

FINANCIAL STRATEGIES

For estate planning and planned giving.

- Legislation
- Court decisions
- IRS developments

UNIVERSITY OF ROCHESTER

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YEAR-END CHARITABLE-PLANNING STRATEGIES

The last quarter of the year is the traditional time for taxpayers to comb their financial fields, looking to harvest tax-saving opportunities. Often they find the most fertile ground ripe with creative charitable-giving strategies.

Charitable giving is unique among tax-reducing strategies in that the ability to capitalize on the opportunities it presents lies almost entirely within the discretion of the taxpayer. While a taxpayer's deduction may, for instance, be limited to the amount of mortgage interest or state and local taxes actually paid, that same taxpayer can decide when to make a charitable gift, the amount of that gift, and the assets that will be used to fund that gift.

There is a general maximum deductible contribution limit of 50% of adjusted gross income (30% for gifts of appreciated long-term capital-gain property). Even in that regard, excess contributions can be carried forward and deducted for up to five additional years.

Something as simple as a straightforward cash gift can be extremely beneficial, reducing federal income tax by up to 35% of the amount of the gift. For the taxpayer who uses charitable-planning strategies creatively to address multiple objectives, the benefits are even greater.

YOUR GAIN DOESN'T HAVE TO BE YOUR LOSS

When it comes to realizing profits on appreciated investments, your gain truly can become your loss. If you sell long-term appreciated capital-gain property, most gain will be taxed at 15% (5% for persons in the 10% or 15% federal income-tax bracket)—and some gain is taxed as high as 28%. However, if you use long-term appreciated property to make charitable gifts, you can reduce or eliminate taxes on unrealized gain, making such property ideal to address a number of planning challenges.

• Taking the Uncertainty Out of the Market

This year has seen the Dow Jones Industrial Average reach its all-time

high. It also has seen the index make multiple triple-digit single-day swings—in both directions. This volatility has left many investors looking for a way to lock in gain.

The traditional way to do that is to sell. But that triggers a capital-gain tax that erodes the amount available for reinvestment.

Example: Joe T bought 1,000 shares of National Widget stock at \$25 per share in 2002. Recently it hit \$75, and Joe would like to sell to protect his \$50,000 profit.

He knows, though, that a sale will also cause him to realize a \$50,000 taxable gain. Because Joe is in the 35% federal income-tax bracket, his long-term capital gain is subject to tax at a rate of 15%. That will result in a tax of \$7,500, eating up 10% of the value of his investment.

The Charitable Option. Assume that Joe also planned to make a

Gift Comparison	Gift of Cash	Gift of Stock
Value of gift	\$75,000	\$75,000
Income-tax savings	\$26,250	\$26,250
Capital-gain tax savings	- 0 -	\$ 7,500
Total savings	\$26,250	\$33,750

significant gift to our organization this year—a gift essentially equal to the value of the National Widget stock. Instead of selling the stock and giving cash, Joe would be much better off to give the stock in kind to us and avoid the tax on capital gain.

• **Navigating the ‘Kiddie Tax’**

Savvy taxpayers are always on the lookout for ways to reduce or eliminate capital-gain tax. Historically, one of the most popular ways to do this has been to shift income to persons in lower tax brackets as part of an intra-family giving program. One of the hurdles standing in the way of this plan has been the so-called kiddie tax that subjects unearned income of some children to tax at the their parents’ rates.

In 2006 the provisions were expanded to apply to children younger than 18—the previous limit had been 14. Now the first \$850 of unearned income of a child subject to these provisions is tax-free and the next \$850 is taxed at the child’s rate. Anything over \$1,700 is taxed at the parents’ rate. Next year the kiddie tax will apply to all children under 19 and dependent full-time students under 24.

As the reach of the kiddie tax continues to grow, taxpayers looking to implement an

intra-family giving plan may find it beneficial to use long-term appreciated capital-gain property to fund their charitable objectives and direct other assets to children. Such a strategy would completely eliminate all capital-gain tax for the entire family and generate a deduction equal to the full fair-market value of the donated property.

REACH OF THE ‘KIDDIE TAX’	
Year	Age Limit
Pre-2006	Under 14
2006 and 2007	Under 18
2008+	Under 19*

* And dependent full-time students under 24

• **Converting Low-Yield Investments to a Source of Income**

Investors sometimes reach a point at which they want more of their assets to generate income as opposed to pursuing capital appreciation. When these times come—often when a person moves into retirement years—good charitable planning can facilitate that transition and reduce the tax cost associated with it.

Example: Joyce R, 70, recently retired after a successful business career. Having invested primarily for growth over

the years, Joyce would now like to convert approximately 20% of her portfolio—about \$500,000—to produce cash flow to supplement her other retirement income.

Joyce is also interested in making a major gift to our organization. After conferring with her advisors, Joyce decides to use \$500,000 of stock that pays no dividends to fund a charitable remainder unitrust that will pay her 6% of its annual value for life. She bought the stock in 2001 for \$200,000. At her death, the remaining trust assets will pass to us.

Her annual income based on the initial value of the trust would be \$30,000, but that will increase if the value of the trust increases. If the trust achieves a total return of 8% each year and Joyce lives her normal life expectancy, her income will grow to more than \$40,000 and more than \$686,000 will pass to us to fund her charitable objectives.

SELL AND REINVEST VS. UNITRUST		
Principal value	\$500,000	\$500,000
Gain recognized	\$300,000	- 0 -
Tax on gain	\$ 45,000	- 0 -
Net reinvested	\$455,000	\$500,000
Income-tax deduction	- 0 -	\$241,600
Income-tax savings	- 0 -	\$84,560
Net cost of plan	\$500,000	\$415,440
First-year income	\$ 27,300	\$ 30,000
Return on net cost	5.46%	7.24%

**The Tax Relief Act of 2001
Impact on Estate and Gift Planning**

Fewer and fewer estates will be affected by the federal estate tax for the rest of this decade as the exemption-equivalent amount climbs to \$3.5 million in 2009 (see chart at right). The tax is repealed for the year 2010. But unless repeal or higher exemption amounts are **re-enacted** into law at that time, the estate tax of 2001 will be back in full force in 2011 with a \$1 million exemption.

Rate and Exemption Schedule		
Calendar Year	Exemption	Highest Tax Rate
2007	\$ 2 Million	45%
2008	\$ 2 Million	45%
2009	\$3.5 Million	45%
2010	Estate Tax Repealed	
2011	\$ 1 Million	55%

The gift produces a charitable deduction equal to the present value of our remainder interest—in this case \$241,600. In her 35% federal income-tax bracket, that saves Joyce \$84,560. In addition, Joyce will not have to recognize any portion of the \$300,000 gain on the stock upon making the gift. Had she sold the stock, that would have generated a capital-gain tax of \$45,000 (15% x \$300,000), leaving her \$455,000 to reinvest. Invested at 6%, that would produce \$27,300 annually.

CHARITABLE PLANNING IN A HIGH-INCOME YEAR

A number of circumstances can lead to an exceptionally high-income year. For instance, the year of retirement is often one of unusually high income for many taxpayers due to such things as special bonuses or redemption of stock options.

Whenever a taxpayer anticipates being in a significantly lower tax bracket in future years, tax-saving strategies in the current year become even more valuable. Utilizing those strategies in the current year will generate maximum tax savings.

If a taxpayer is planning a major charitable gift at some point in the near future and expects to be in a lower bracket in the future, it may be prudent

to make that gift now. Even if a person simply plans to continue a typical pattern of annual gifts, it may be beneficial to accelerate the deductibility of those gifts.

Example: Upon his retirement this year, Charles G received a substantial bonus and redeemed a large amount of stock options that pushed him well into the 35% federal income-tax bracket. Charles anticipates being in the 28% bracket in the future.

Charles has been a faithful supporter of our organization and plans to continue his typical annual gift of \$40,000 indefinitely. To facilitate this and to take advantage of the opportunity to generate a large deduction in this, his highest-income year, Charles transfers \$500,000 to a grantor charitable lead annuity trust that will distribute \$40,000 to us each year for the next 20 years. At the end of the trust term, the remaining trust assets will revert back to Charles (or pass according to his estate plan if he is no longer living).

Charles is entitled to deduct this year the present value of our right to receive the 20 annual payments—a deduction of \$468,980 based on a 6% discount rate. In the 35% bracket, this saves Charles \$154,134. If he invests the tax savings at 6%, that will grow to \$494,329 at the end of the trust term.

If he simply continues his pattern of annual gifts, his \$40,000 gift this year will save him \$14,000 and future gifts in the 28% bracket will save \$11,200 each year. If those savings are invested at 6%, they will accumulate to \$445,699 at the end of the 20 years. This means Charles will be ahead by almost \$50,000 by using a grantor lead trust.

The creator of a grantor lead trust remains taxable on the income of the trust during its term. However, the exact amount that is taxable depends on how the trust is invested. If it is invested primarily in securities, there will only be tax when assets are sold.

The grantor lead trust is an income-tax planning tool. Conversely, a nongrantor lead trust can be a powerful gift- and estate-tax planning tool, but it generates no current income-tax benefit.

With a nongrantor lead trust, assets remaining in the trust at the end of the trust term pass to noncharitable beneficiaries other than the grantor. The grantor is not taxable on the trust's income but is liable for the gift or estate tax on the present value of any interest passing to noncharitable beneficiaries. In determining that value, the present value of the charitable interest is subtracted

E-Mail Discussion Lists for Gift Planners

- **ABA-TAX** A tax-law Internet discussion group sponsored by the American Bar Association Tax Section. Participation is limited to practitioners, law professors, and law students. <http://www.abanet.org/tax/linfo.html>
- **ABA-PTL** Sponsored by the Probate Division of the Real Property, Probate & Trust Law Section of the American Bar Association, intended primarily for the use of Section members and related professionals so they can discuss estate-planning and administration issues by e-mail. <http://mail.abanet.org/scripts/wa.exe?SUBED1=aba-ptl&A=1>
- **FUNDSVCS** Fundraising services technical discussion list. <http://lists.duke.edu/archives/fundsvcs.html>
- **Yahoo PLANNED GIVING** An open list for discussion of gift-planning topics. <http://groups.yahoo.com/group/plannedgiving/>
- **GIFT-PL** National Committee on Planned Giving members-only discussion list for all issues and queries related to gift planning. http://www.ncpg.org/members/gift_pl.asp?section=4

from the amount transferred to the trust initially and only the balance is subject to gift or estate tax.

In many cases the value of the charitable interest greatly reduces or even eliminates the value of the noncharitable interest, resulting in substantial gift- or estate-tax savings. At the end of the trust term, all assets remaining in a nongrantor lead trust pass to the noncharitable beneficiaries free of any further gift or estate tax—regardless of how much the trust might have grown.

LAST CHANCE FOR TAX-FREE ROLLOVER OF IRA FUNDS

The Pension Protection Act of 2006 created the opportunity for certain taxpayers to transfer funds directly from their IRA accounts without the amount transferred being treated as a taxable distribution. That special provision is set to expire at the end of 2007.

In order to take advantage of this opportunity, certain provisions must be met:

- Donor must be aged 70½ or older at the time of the gift
- Transfer must go directly from IRA to qualified charities
- Transfers up to \$100,000 per taxpayer per year qualify
- Gifts must be outright—no “life income” gifts

This opportunity expires at the end of 2007 and no deduction is allowed for the gift.

PPA also includes a bit of a “bonus” in that amounts transferred to charity under these provisions can also count against the minimum required distribution (MRD) an account owner must take for the year.

A direct IRA transfer may be particularly appealing to certain groups of taxpayers:

- **Donors whose other charitable gifts exceed the annual 50% of AGI limit.** PPA transfers do not count against the 50% limit nor reduce the amount of otherwise deductible gifts. This allows the donor to fund charitable gifts with potentially taxable assets with no tax cost.

- **Donors in states that do not allow itemized deductions for charitable contributions.** In such states, if a taxpayer makes a distribution directly from an IRA to charity, he or she will avoid the amount of the state income tax that would have been due on a personal distribution, even if it is fully deductible for federal purposes.
- **Non-itemizers.** This is especially true for those who elect to count direct charitable transfers against their MRD. In that scenario, the donor effectively gets the benefit of the deduction since part of the required distribution is not subject to income tax.
- **Taxpayers who face reduction of other tax benefits as a result of IRA distributions.** If a taxpayer is already subject to reduction of some deductions and exemptions because his or her income has crossed the reduction threshold, additional IRA distributions will only exacerbate the problem. Amounts transferred directly to charity do not count against the threshold.

Financial Strategies is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep philanthropic planners up to date on developments in estate planning as they relate to testamentary and lifetime plans of support of qualified charities.

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