Financial Planning Perspectives

Charitable giving: Three steps for a successful plan

In 2015, charitably inclined investors donated an estimated $373 billion to organizations across the United States (The Giving Institute, 2016).[1] Their reasons varied, but regardless of the purpose, a successful charitable giving plan involves three steps: determining *when* to give, *what* to give, and *how* to give. We examine some common charitable giving strategies, discuss the advantages and disadvantages of each, and present examples to show their effects.

Step 1: Determine *when* to give.

The timing of charitable gifts can have financial consequences for the donor, the donor's heirs, and the charity. The donor's cash flow needs, purpose for giving, desire to pass assets on to heirs, and estate and tax planning needs should all be considered.

Step 2: Choose *what* to give.

The type of property donated can also have a big financial effect. Cash tends to be easiest. However, donations of appreciated securities or property may yield an equivalent benefit to the charity but carry much greater tax and estate planning advantages for the donor.

Step 3: Decide *how* the gift will be made.

The many methods of giving include direct gifts, bequests, charitable trusts, and donor-advised funds. Each has its benefits and considerations and can serve very different goals. Selecting the right method is critical to the success of the donor's giving strategy, investment plan, and overall estate plan.

1 For the purposes of this paper, we assume the investor is charitably inclined. Although donations may offer income and estate tax advantages, the benefits will rarely, if ever, outweigh the cost of the gift.

Note: Throughout this paper, we discuss only the *federal* tax consequences of the strategies described. State laws vary widely and may differ from federal tax laws. Tax discussions are based on current rules and regulations in effect as of the writing of this paper and are subject to change at any time. Investors should consult with their tax advisor before engaging in any transaction that may have tax consequences.

Step 1: Determine when to give

A detailed examination of the donor's needs and goals is necessary to determine the optimal timing of the gift. For example, a donor who lacks the means to make a large gift or has concerns about a charity's ability to manage such a gift may wish to make a smaller initial donation. He or she can then wait to see how the charity manages or uses it and make additional gifts in the future, if appropriate. The strategy may differ for a donor who wants to fund either an established charity with a high degree of sophistication in managing gifts or a specific project. In this case, he or she may wish to make a large one-time gift or a series of ongoing gifts to help fund the project or charity over a longer term.

The timing of the gift—whether a single donation or a series of gifts—depends on the charity as well as the donor's intent and cash flow situation.

The donor's tax planning and cash flow needs must also be assessed. Cash flow considerations can be both real and psychological. Although a donor may objectively be able to afford to make a lifetime gift, subjective concerns may make a bequest more appropriate. For purposes of tax planning, clients with more taxable income at present than they expect in the future may wish to accelerate their giving during the high-income years to maximize their charitable income tax deduction.

Working with a financial planner to help balance charitable goals, cash flow needs, tax planning, and other considerations can significantly increase the chances of a wealth plan's success.

Step 2: Choose what to give

From a tax and estate planning perspective, the type of property donated makes little difference to the charity but can have a large effect on the donor.

Cash is king when it comes to simplicity

The simplest and easiest property to donate is cash. The donor has full control over the amount and timing of the donation and receives a tax deduction for the total amount, subject to IRS limitations (see **Figure 1**).

Appreciated securities—one gift, multiple benefits[2]

Donating appreciated securities can provide tax benefits beyond those of a cash donation. As they can with cash, donors can control the timing and amount of the gift and receive a tax deduction for the fair market value of the securities. Additionally, they do not have to recognize (or pay taxes on) the unrealized gains. This added benefit can be an excellent way to further the donor's charitable intent while simultaneously lowering his or her tax bill.

2 Although any securities can be donated, gifting of appreciated securities will typically have the greatest tax advantages. Investors who are considering donating securities or other property at a loss may often be better off selling the asset, recognizing the loss, and donating the resulting proceeds. They should consult with their tax advisor, as the rules regarding how much they may deduct for donations of this type of property are complex.

Figure 1. Tax impact of donating cash versus appreciated stock

Example: Bob and Jill Brown are married and file a joint tax return. They have adjusted gross income of $100,000 and decide to donate $10,000 to charity. They will fund this gift using 50 shares of stock that they bought several years ago for $100 each but that are now worth $200. The tax impact of gifting the stock versus selling it and making a cash gift of $10,000 are shown below. By gifting the shares in-kind, Bob and Jill realize an additional tax benefit of $750.

Gifting appreciated securities may be more complex than gifting cash but has potentially greater tax benefits.

Key observations:

- Charitable donation, taxable income, and income tax due are identical.
- Gifting appreciated securities results in additional tax benefit of $750 from nonrecognition of gains.

$100,000 Income – $10,000 Charity = $90,000 Taxable income

$14,094 Income tax

Donation

Cash		Appreciated securities
$14,094	Income tax	$14,094
$5,000	Capital gains	$—
$750	Capital gains tax	$—
$14,844	Total taxes owed	$14,094

Note: Income tax is calculated using IRS 2015 tax tables and assumes a 15% long-term capital gains tax rate.

Source: Vanguard.

In order to avoid recognition of capital gains, donors must have held securities for at least one year and gift them in-kind. In-kind transfers require paperwork, making them more complicated than cash gifts, and the transfer can take from several days to several weeks. Because the value of the securities will likely fluctuate during this time, the donor has less control over the exact amount the charity ultimately receives.[3] Also, because deduction limits on gifts of appreciated securities are different than those for cash gifts (see **Figure 2**), it's best to consult with a tax advisor when considering this strategy.

Other appreciated property: more potential benefits, more uncertainty

A gift of appreciated property can be complex, but since the charity is responsible for selling the property, it can save the donor time, effort, and money.

Virtually any type of property may be donated, including real estate, automobiles, art, and collectibles. As with appreciated securities, a gift of appreciated property held for more than one year allows the donor to take a deduction for the fair market value of the property on his or her income tax return while avoiding recognition of capital gains. Additionally, the charity takes on the responsibility of selling the property. This can result in significant savings of money, time, and effort for the donor, because commissions on the sale of property can be substantial and finding a buyer can be a lengthy process.

Considerations when donating appreciated property are similar to those involved in donating appreciated securities; however, their magnitude can be much greater. A gift of real estate, for example, can involve significantly more paperwork, including deeds, tax records, and other documents. Also, it may take a long time for the charity to sell the property, during which its value could change greatly.[4] Finally, valuing property can be a difficult and imprecise process, rules on the deductibility of property gifts are complex, and not all charities will accept them.[5] Donors should check with their charity of choice and engage appropriate appraisal and tax professionals when contemplating this type of gift.

Figure 2. Benefits to donor of gifting appreciated assets

	Income tax deduction[6]	Additional tax benefits	Additional non-tax benefits	Complexity of making gift
Cash	Amount of gift up to 50% of AGI	$—	$—	Low
Appreciated securities held more than one year	Fair market value of securities up to 30% of AGI[7]	Nonrecognition of capital gains	No transaction costs (commissions, etc.)	
Other appreciated property held more than one year	Fair market value of property up to 30% of AGI	Nonrecognition of capital gains	No transaction costs; charity responsible for sale of property	High

Source: Vanguard.

3 Although the value of the donated securities may change during the transfer period, for the purposes of the donor's tax deduction, the gift is valued on the date the donor initiates the transfer, not the date the charity receives the shares.

4 Like a donation of securities, the gift is valued as of the date of transfer for the purpose of determining the donor's income tax deduction. Only the value the charity receives upon sale may change.

5 Advisors and consultants to less sophisticated or resource-limited nonprofit organizations may wish to advise them to draft a gift acceptance policy if they do not already have one. This can help prevent these clients from accepting illiquid or otherwise burdensome gifts.

6 Assumes charity is a 50% charity as defined by the IRS. Deductibility limitations for some organizations are lower.

7 Donors may also choose to deduct their basis in the donated property at a limit of up to 50% of AGI.

Step 3: Decide how the gift will be made

Once investors have determined the "when" and "what," the final step is to determine the "how."

Below, we review common charitable goals and the strategies that can help donors meet them.[8]

Immediate charitable gift

Using the simplest and most common method of giving, the donor gifts assets of cash or property that will not be needed during his or her lifetime. The donor receives a deduction for the full value of the gift in the year it is given (subject to IRS limitations; see Figure 2). The gift (along with its future growth) is removed from the donor's estate and does not count against his or her lifetime exemption.[9]

Donors over age 70½ may wish to consider a qualified charitable distribution.

The two most widely used strategies are a tax-deductible gift and a nondeductible gift from a qualified retirement account,[10] known as a qualified charitable distribution, or QCD.

A QCD is unique in that the gift counts toward the required minimum distribution (RMD) but is not recognized as income for tax purposes. Because many tax-related items, including itemized deduction and exemption phase-outs, net investment income tax, taxability of Social Security, and Medicare Part B premiums, for example, are based on AGI, QCDs are potentially more attractive than taking the RMD and making deductible gifts (which do not reduce AGI) from either the RMD or other sources.

For a gift to qualify as a QCD, donors must be age 70½ or older, the distribution must be made payable directly to the charity by the IRA custodian,[11] and the recipient must be a "public charity" as defined by the IRS. Donations to private foundations, donor-advised funds, and certain other entities do not qualify for QCD treatment. Other restrictions exist as well, so donors should make sure they are familiar with the rules.

8 Some of these methods can be very complex, and their appropriateness is not always apparent. Donors are strongly encouraged to consult with their financial planners before engaging in any charitable giving strategy.

9 For 2016, the federal gift and estate tax exemption is $5,450,000 per individual. This is the total amount that an individual can pass free from gift and estate taxes. Lifetime gifts that use a portion or all of the exemption are deducted from the estate tax exemption amount when calculating the taxable estate. Any assets held by the estate in excess of the remaining exemption are taxed at a maximum rate of 40%.

10 Qualified retirement accounts for purposes of a QCD include traditional IRA accounts or inactive SEP or SIMPLE accounts. An inactive SEP or SIMPLE is one that has not received employer contributions during the year. Technically, QCDs may also be made from Roth IRAs, but because distributions from Roth IRAs are tax-free, this is of limited benefit.

11 The check may be mailed to the donor for delivery to the charity; however, it must be made out directly to the charity.

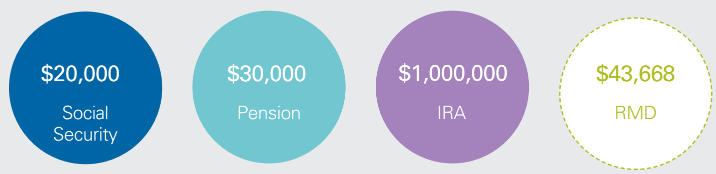
A QCD can provide additional benefits by reducing AGI.

Figure 3. Tax impact of deductible donation versus QCD

Example: John and Rita Smith, both 75 years old, are a married couple who file a joint return. This year, they had combined Social Security benefits of $20,000 and pension income of $30,000. They also have an IRA that, at the end of last year, had a balance of $1,000,000. Their calculated RMD is $43,668. John and Rita do not need the income from their IRA and decide to donate that amount to charity. The income tax impact of a deductible donation versus a QCD is shown below.

Key observations:

- When the Smiths take an RMD (rather than making a QCD), their AGI rises, subjecting more of their Social Security income to tax.
- The QCD leads to tax savings of about $1,000.



	Deductible donation	QCD
Income and AGI		
Social Security benefits	$20,000	$20,000
Pension	$30,000	$30,000
RMD	$43,668	$43,668
QCD	$—	($43,668)
Adjusted gross income (Social Security benefits + pension + RMD – QCD)	$93,668	$50,000
Taxable percentage of Social Security	85%	50%
Taxable income		
Taxable Social Security (Social Security benefits x taxable percentage of Social Security)	$17,000	$10,000
Other taxable income (AGI – Social Security benefits)	$73,668	$30,000
Charitable deduction	($43,668)	$—
Total taxable income (taxable Social Security + other taxable income – charitable deduction)	$47,000	$40,000
Income tax due	$6,131	$5,081

Notes: 50% of Social Security benefits are taxable for married taxpayers filing jointly with a base income (1/2 of Social Security benefits + other taxable income) of $32,000 to $44,000 ($25,000 to $34,000 for single filers) and 85% for taxpayers with a base income above those amounts (see *IRS Publication 915* for details). Income tax is calculated using IRS 2015 tax tables.

Source: Vanguard.

A gift intended to meet charitable and other financial goals

It may be possible for the same portfolio of assets to support both charitable and other financial planning goals such as a bequest to family members or income for the donor. "Split-interest" trusts, charitable gift annuities, and bequests are several of the ways to accomplish such multiple goals.

Properly constructed, a split-interest trust can provide a benefit to the donor, the charity, and the donor's beneficiaries. The most common types of split-interest trusts used in charitable giving plans are the charitable lead trust and the charitable remainder trust.[12]

Charitable lead trust (CLT)

In a CLT, the donor grants income from the trust to a designated charity for a fixed period of time. After that period, the remaining funds in the trust are passed on to non-charitable beneficiaries named by the grantor. The donor, the charity, and the donor's beneficiary all benefit:

Charitable lead trusts can further a donor's charitable giving strategy and shelter assets from estate tax.

Figure 4. Benefits of a charitable lead trust

Donor	Receives an income tax deduction equal to the present value of the income stream paid to the charity[13] at the time the trust is funded. The entire amount deposited to the trust and its subsequent growth is removed from the donor's estate. Capital gains on assets transferred to the trust are not recognized.
Charity	Receives a predictable income stream.
Beneficiaries	Receive any assets remaining at the end of the trust period free from estate taxes.

Source: Vanguard.

The actuarial value of the gift passed to the beneficiaries (which is less than the value of the entire gift) will count against the donor's lifetime exemption or be subject to gift tax. Also, because of market volatility during the years income is paid to the charity, there is no way to determine in advance how much will be passed to the beneficiaries. Therefore, donors should take care when determining what portion of trust assets to give to a charity and how long the income stream should last.

12 We focus on annuity trusts (CLAT/CRAT) for the purposes of this discussion. Unitrusts (CLUT/CRUT) also exist, which have different income and remainder payout profiles.

13 The donor must claim the income paid to the charity each year on his or her personal income tax return, even though the charity is receiving the income. If the donor elects to take an upfront deduction for the present value of the income stream, no deduction is permitted in future years.

Charitable remainder trust (CRT)

In many ways, a CRT is the opposite of a CLT because the remainder and income portions are reversed. A non-charitable beneficiary, usually the grantor, receives the income from the trust for his or her lifetime or a period of years, and the charity receives the remaining assets. As with a CLT, the donor, the charity, and the beneficiary of the trust all benefit:

A charitable remainder trust can provide the donor with a lifetime income and benefit charity at the donor's death.

Figure 5. Benefits of a charitable remainder trust

Donor	Receives an income tax deduction for the actuarial value of the remainder interest[14] of the trust in the year it is formed. The entire amount deposited to the trust and its subsequent growth is removed from the donor's estate. Capital gains on assets transferred to the trust are not recognized.
Charity	Receives any assets remaining at the end of the trust period free from estate taxes.
Beneficiaries	Receive a predictable income stream.

Source: Vanguard.

There is no way to determine in advance how much the charity will receive, and there may be gift tax consequences if the non-charitable beneficiary is someone other than the grantor. Therefore, as with a CLT, donors should give careful consideration to a CRT's design.

Charitable gift annuity

A charitable gift annuity shares many of the features of a CRT. The donor gives the assets to a charity and receives an income stream in return, along with tax benefits—a deduction,[15] nonrecognition of capital gains, and removal of the donation from the estate. Unlike in a CRT, however, the donated assets are not placed into a trust but immediately become the property of the charity, which guarantees the income stream. This can provide an extra benefit to the grantor because the beneficiary is unlikely to outlive the income stream regardless of investment performance. Charitable gift annuities also tend to be easier to set up than CRTs because they are administered by the charity; however, their payout rate may be lower.

Bequest

A bequest is a gift left to a charity after the donor's death. Donors can make bequests by means of a will, revocable trust, or beneficiary designations on accounts or insurance contracts. It is, in many ways, similar to an immediate gift, except that it occurs at a future date (the death of the donor). As a result, the donor has full use of the gift during his or her lifetime. The donor will not receive an income tax deduction at the time the bequest is documented. However, the estate can claim a deduction for the full amount of the bequest from the estate tax return.[16]

14 The charitable deduction for a CRT is equal to the present value of the expected remainder interest. This amount is complex to calculate and requires the assistance of a tax professional.

15 Similar to that for a CRT.

16 However, the estate cannot take a charitable deduction on its income tax return.

Figure 6. Tax impact of charitable trust versus bequest

Example: Bill and Sarah Jones, both 65 years old, are a married couple who wish to make a $1,000,000 charitable donation. They would like the donated assets to benefit both the charity and themselves or their beneficiaries. Their financial planner suggests they consider a charitable lead trust, a charitable remainder trust, or a bequest. The benefits of the three options to the Joneses, the charity, and their beneficiary are as follows.

Key observations:

- In each case, the charity receives about $1 million, either all at once or in smaller increments over time.
- The trusts reduce the value of the donor's estate by the same amount but produce different income tax deductions. The CLT also results in gift taxes.
- Compared with the trusts, the $1 million bequest produces a smaller reduction in the donor's estate. Because of the time value of money, a $1 million gift 20 years in the future is worth less than $1 million given to a trust today.

Charitable lead trust | Charitable remainder trust | Bequest

	Impact on donor				Amount received by charity		
	Income tax deduction	Annual income	Estate reduction	Amount subject to gift tax	Annually	At end of trust term/ death of donor	**Amount received by beneficiary at end of trust term**
Charitable lead trust	$850,030	$—	$3,207,135	$149,970	$50,000	$—	$1,367,856
Charitable remainder trust	$149,970	$50,000	$3,207,135	$—	$—	$1,367,856	$—
Bequest	$—	$20,000	$1,000,000	$—	$—	$1,000,000	$—

Notes: The income tax deduction assumes the deductible amount is within IRS limits. All calculations assume a constant 6% rate of return. Charitable remainder and charitable lead trust amounts are based on an initial deposit of $1,000,000, annuity payments of $50,000 annually over 20 years, and an IRS §7520 rate of 1.6%. Income for the bequest assumes $1,000,000 invested in a 20-year bond at 2%. Estate reduction amounts are based on the future value of the gift after 20 years at the assumed rate of return. Figures are illustrative only. Actual amounts would vary depending on realized returns. This hypothetical illustration does not represent the return on any particular investment and the rate is not guaranteed.

Source: Vanguard.

Donor-advised funds can allow donors to fund a long-term giving strategy over a relatively short period of time.

A gift today for distribution in the future

Some donors may be ready to make a gift—and potentially realize tax- and estate-planning benefits—but not yet ready to distribute the money to their selected charities. Below are two strategies they can use to make future gifts.

Donor-advised fund (DAF)

A DAF is a separate charitable account maintained and operated by a tax-exempt sponsoring organization. The donor makes one or more deposits to the account from which grants are funded and makes recommendations as to how the account should be invested, which charities should receive grants, and what the grant amounts should be.[17] Grants may be made over time, but because the sponsoring organization is a public charity, the donor receives an immediate tax deduction for the entire amount of the gift(s) in the year(s) made (subject to IRS limitations). The donor has no tax filing requirement and is not subject to minimum annual gifting rules (unlike a private foundation).[18] DAFs can be a good option for donors who want to fund a long-term giving strategy over a relatively short period of time without being subject to the rigorous Treasury regulations that govern private foundations.

Donors should keep in mind that sponsoring organizations charge a fee for their services. They may also restrict minimum deposits, grant sizes, the types of property or securities accepted, and the charitable organizations that qualify for grants.

Private foundation

A private foundation is a charitable organization created by the donor and administered by the donor or others hired to do so. Depending on its purpose, a foundation may make charitable gifts to individuals or organizations, with the foundation's board of directors deciding how large each grant should be. Generally, private foundations must distribute at least 5% of their assets annually. Donations are tax-deductible, but the limitations on deductibility are different (generally lower) than they are for gifts to public charities.

Private foundations are complex to form and strict IRS reporting requirements and regulations govern their operation. They can be very expensive to set up and administer and may not be appropriate for all donors.

17 The donor may also name another person or entity as advisor to the fund to manage these functions.

18 Although DAFs are not required to make a minimum gift each year as private foundations are, they are required to make periodic gifts both during and after the donor's lifetime. While there is more flexibility in the timing as compared with a private foundation, gifts must still be made from the fund.

Figure 7. Tax impacts of DAF, private foundation, and annual gift

Example: Tom and Joan Moore want to donate $1,000,000 to charity, but they are not ready to commit the entire donation to a single charity. They are retiring this year and will be cashing out their stock options. As a result, their income this year will be $2,000,000, but they expect their income to be only $50,000 per year after that. They are considering a private foundation, a DAF, or a series of annual gifts of $50,000 a year for the next 20 years. The impact on the Moores is as follows.

Key observations:

- In each case, the charity receives about $1 million, either all at once or in smaller increments over time.
- A gift to a donor-advised fund produces the largest income tax deduction, taking full advantage of deductibility limits in a year of unusually high income. These limits are lower for a private foundation.
- Compared with a foundation and a DAF, annual gifts produce a smaller reduction in the donor's estate. Because of the time value of money, a $1 million gift over 20 years is worth less than $1 million given to a foundation or DAF today.

Annual gifts of $50,000

Private foundation

Donor-advised fund

	Impact on donor					
	Income tax deduction first year	Income tax deduction years 2–20	Total income tax deduction over 20 years	Estate reduction	Required annual gift	**Amount received by beneficiary**
Annual gifts of $50,000	$50,000	$25,000	$525,000	$1,839,280	$50,000	$—
Private foundation	$600,000	$—	$600,000	$3,207,135	$50,000	$—
Donor-advised fund	$1,000,000	$—	$1,000,000	$3,207,135	$—	$—

Notes: Income tax deductions are based on deductibility limits of 50% of AGI for public charities and 30% for private foundations. Estate reduction is calculated as the future value of the gift(s) over 20 years at a 6% rate of return. Income tax deduction in years 2–20 for the annual gift is limited to $25,000 because of the 50% deductibility limit ($50,000 income x 50% = $25,000). This hypothetical illustration does not represent the return on any particular investment and the rate is not guaranteed.

Source: Vanguard.

Conclusion

Charitable giving is an important goal for many investors. Although any form can be beneficial, proper planning of the when, what, and how can help maximize the donor's philanthropic as well as overall wealth planning goals. The rules regarding some of these strategies are very specific and complex. Therefore, individuals should consult with tax and estate planning professionals before engaging in any charitable giving plan.

Reference

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