LINCOLN COMMUNITY FOUNDATION

Fall 2016

CHARITABLE GIVING

a resource for charitable gift planning professional advisors

LINCOLN COMMUNITY FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

Bonus Link:

Planned Giving Answers Online -
A Technical Resource Library

A Plan That Works: Year-End Gift Solutions

During World War II, the limited range of Allied aircraft left the north Atlantic painfully unprotected from German U-boats, which were able to control vital shipping lanes. While military strategists pondered the problem, an eccentric inventor named Geoffrey Pyke came up with a novel idea to extend the range of air power—building an aircraft carrier out of ice. His theory: ice is cheap, buoyant, durable (especially when mixed with wood fibers), and able to withstand torpedoes with minimal and easily repairable damage. After selling Winston Churchill on the idea, plans for building the ship proceeded under the name Project Habbakuk.[1]

Unfortunately, while ingeniously designed, the ice ship would have been slow and difficult to steer. What's more, planning for the project took so long that more conventional solutions came into play. As engineers enhanced aircraft capabilities and code breakers improved their skills, the Allies avoided the enemy with greater success and Project Habbakuk fell by the wayside.

This issue of ***Charitable Giving*** looks at solutions to a far simpler and more common problem—finding the best way for a donor to make a satisfying year-end gift. Luckily, there's no need to develop a novel, Habbakuk-like solution. In fact, the opposite is true. There are so many time-tested tools and techniques available that the real problem becomes determining which option will be most effective for each particular client.

Sometimes, Basic is Best

A simple gift can accomplish significant goals. By taking advantage of clearly established income tax rules, donors can make noteworthy gifts that also contribute to their personal finances.

Gift Annuities

A charitable gift annuity is simply a contract between a donor and a qualified charity. A donor exchanges cash or property (often long-term appreciated assets) for a lifetime of income paid to one or two annuitants. Donors like gift annuities because they are easy to understand and execute. Moreover, donors who want to make a series of smaller gifts over time can choose to "ladder" multiple annuities. Consider these benefits:

- An immediate income tax charitable deduction on the gift portion of the transaction (partially deferred if necessitated by the AGI deduction limits)[2]
- A fixed income that provides a hedge against uncertain financial markets, with a current rate that is more attractive than most interest-bearing, fixed-income investments
- The ability to defer payments to coincide with retirement or another life event, resulting in additional benefits (a larger charitable income tax deduction and an increased annuity payment)

LINCOLN COMMUNITY FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

- Sometimes, Basic is Best
- Ramping Up Use of Retirement Assets
- Charitable Trusts: Combining the Personal and the Philanthropic
- Conclusion

Bonus Link:

Planned Giving Answers Online -
A Technical Resource Library

- The right to designate a second annuitant, either consecutively or as joint-and-survivor annuitants
- A tax-free portion of each payment
- Removal of transferred assets from the donor's estate for estate tax purposes

With the current low applicable federal interest rates (AFRs), donors have a unique opportunity to lock in a high income for life, with a portion of each payment received tax free. For example, a 75-year-old donor could get a 5.8% lifetime payout, with more than two-thirds of each payment free of income tax. Gift annuities make the most sense for elderly donors, since the tax benefits improve as the donor's life expectancy under IRS tables shrinks. However, younger donors may be interested in deferred gift annuities as a way to supplement future retirement income.

Gifts of Appreciated Property

A gift of appreciated stock or mutual fund shares (held for more than one year) is both simple and tax efficient. The donor receives an income tax charitable deduction for the full fair market value of the donated shares and pays no long-term capital gains tax on the appreciation. This leveraging of untaxed gain to generate a tax deduction substantially reduces the tax on reportable income.

> **Example:** Glenda purchased stock for $1,000 ten years ago that is now valued at $5,000. If she sells the stock, she will incur a capital gains tax of $600 ($4,000 appreciation x 15% capital gains tax rate). Instead, Glenda chooses to use the stock to make a charitable gift. In her 33% tax bracket, she enjoys a deduction of $1,650 for the full fair market value of the stock ($5,000). She also avoids the $600 capital gains tax liability she would have paid if she sold the stock. Therefore, the net cost of her gift is only $2,750 ($5,000 – $1,650 – $600) compared to $3,350 for a cash gift of $5,000.

Note: The charitable deduction for appreciated long-term capital gain property is limited to 30% of adjusted gross income (AGI). The donor may carry over any excess deduction for up to five years.[3]

The IRA Charitable Rollover

An IRA charitable rollover (more technically, a qualified charitable distribution or QCD) is a reliable annual gift option since Congress made it permanent in 2015.[4] A QCD allows a donor age 70½ or older to make a tax-free transfer (up to $100,000) from a traditional or inherited IRA[5] directly to a qualified charity.[6] The amount transferred is not eligible for a charitable income tax deduction, but it counts toward the donor's annual required minimum distribution (RMD). This is an especially attractive option for relatively well-off donors who are forced to take IRA withdrawals that they do not need.

It is vital to keep in mind that a QCD can only be accomplished by a direct transfer from the IRA to the charity. An IRA owner who actually receives a distribution is subject to ordinary income tax, even if the owner immediately transfers the distribution to charity. Instead of a QCD, this would be considered a cash gift (but as cash, it would be eligible for a charitable deduction).

LINCOLN COMMUNITY FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

Bonus Link:

Planned Giving Answers Online - A Technical Resource Library

Example: Ron takes his required minimum distribution from his IRA. Recalling an article about the IRA charitable rollover, he decides he does not need the funds and writes a check to his favorite charity for the entire amount of the RMD. His accountant later informs him he must report the RMD as taxable income and is only entitled to deduct the amount donated. Unfortunately for Ron, this income pushes him into a higher tax bracket, subjecting him to additional net investment income taxes that are triggered when income exceeds certain threshold amounts.[7]

Ramping Up Use of Retirement Assets

Because retirement assets are highly taxed, they make excellent candidates for charitable gifts. While the qualified charitable distribution is a strong option, those who are not yet 70½ or who do not have an IRA can still make effective use of retirement assets to make charitable gifts.

Taking a Distribution, Making a Gift

Taking a distribution and donating that money to charity is basically the same as making a cash gift, since retirement plan distributions are usually taxable as ordinary income. These gifts:

- Reduce a donor’s taxable estate
- Provide a current income tax deduction for a cash donation (or a deduction for the present value of the remainder interest to the charity if the donor directs the money to a charitable remainder trust or charitable gift annuity)

A Testamentary Gift of Retirement Assets

Those with large estates often reap additional benefits by making a testamentary transfer of retirement assets instead of a current gift. Why?

Retirement assets are prime examples of income in respect of a decedent (IRD)—income earned prior to death (or to which an individual had a right prior to death) that was not includible in gross income before death. IRD has the potential for double taxation—once in the estate (federal estate tax) and again to the recipient (federal income tax). A decedent in a 40% estate tax bracket and a recipient in a 39.6% income tax bracket will potentially lose a majority of the retirement assets or other IRD property to these combined taxes.[8]

By bequeathing retirement assets to charity, the donor removes them from the estate (avoiding any estate taxation on that amount). Since the charity pays no income taxes, it can put every dollar to work. Such a bequest creates a future estate tax deduction, and heirs can benefit from receiving other assets, particularly if they receive a step-up in basis.

Example: Paul’s estate is well over the current estate tax exemption of $5.45 million. He would like his brother, Charlie, and the local animal shelter to receive $1 million each at his death. He owns $1 million of appreciated stock and has $1 million in a 401(k) plan. His advisor suggests leaving the stock to Charlie and the 401(k) assets to the shelter. Why?

LINCOLN COMMUNITY FOUNDATION

Fall 2016

CHARITABLE GIVING

a resource for charitable gift planning professional advisors

As a tax-exempt entity, the animal shelter is not taxed upon receipt of the retirement assets and can apply the entire $1 million to its charitable purposes. Moreover, Paul's estate receives a charitable deduction for the entire gift. Charlie will not owe any income tax on the stock he inherits and he will benefit from a step-up in basis.

If Paul had left the 401(k) assets to Charlie and the stock to the shelter, the shelter would still have been able to use the entire $1 million and Paul's estate would still have received a charitable deduction, but both Paul's estate and Charlie would have had to pay sizeable taxes on the 401(k) assets.[9]

The most straightforward method of leaving a testamentary charitable gift of retirement assets is simply to designate the charity as the beneficiary on forms provided by the custodian of the retirement funds.[10] Of course, donors must understand that the beneficiary designation controls the distribution of an IRA or retirement plan, and will always take precedence over any conflicting distribution instructions found in a will or trust.[11]

Example: Maggie's $7 million estate includes an IRA worth $700,000. She intends to give one-tenth of her estate to her favorite charity, so she uses the forms provided by the IRA custodian to name the charity as the sole beneficiary of her IRA. At Maggie's death, the charity receives the $700,000 tax free, avoiding both the estate tax and the income tax that her heirs would have had to pay upon receiving her IRA assets, and her estate receives a $700,000 charitable deduction. The amount that remains in her estate over and above her exemption is subject to the federal estate tax.[12] The non-IRD assets, less estate tax costs, are distributed to her heirs, who enjoy a step-up in basis. Total tax savings are roughly $400,000—a very cost-effective giving strategy.

Sources of Retirement Funds

Donors are sometimes confused by (or even unaware of) the retirement vehicles they own. Here are some of the common sources of retirement funds that donors can tap for charitable gifts:

- Qualified Plans
  - Profit Sharing (including plans with an IRC §401(k) feature)
  - Money Purchase
  - Defined Benefit (including Cash Balance)
  - ESOP (Employee Stock Ownership Plan)
- IRC §403(b) Tax Deferred Annuities
- IRC §457(b) Deferred Compensation
- IRAs (Traditional and Roth), SEPs and SIMPLEs
- Nonqualified Deferred Compensation Arrangements

LINCOLN COMMUNITY FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

- Sometimes, Basic is Best
- Ramping Up Use of Retirement Assets
- Charitable Trusts: Combining the Personal and the Philanthropic
- Conclusion

Bonus Link:

Planned Giving Answers Online -
A Technical Resource Library

LINCOLN COMMUNITY FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

- Sometimes, Basic is Best
- Ramping Up Use of Retirement Assets
- Charitable Trusts: Combining the Personal and the Philanthropic
- Conclusion

Bonus Link:

Planned Giving Answers Online -
A Technical Resource Library

LINCOLN COMMUNITY FOUNDATION

Fall 2016

CHARITABLE GIVING

a resource for charitable gift planning professional advisors

Charitable Bequests of Nonqualified Plan Assets

In the simplest terms, a nonqualified deferred compensation plan or arrangement simply defers the payment of a portion of an employee's compensation to a future date (either as a result of a reduction in current income or in addition to current income). These plans are typically designed to benefit executives and other highly paid individuals. Benefits are not taxed until they are considered vested at death, disability or retirement. Such an arrangement is "nonqualified" in the sense that it is an unfunded arrangement that need not meet the technical requirements imposed on qualified pension and profit-sharing plans under the Internal Revenue Code or the Employee Retirement Income Security Act (ERISA). As such, it allows employers to discriminate in favor of highly paid employees. However, the plan must still meet stringent requirements of IRC §409A.[13]

Since deferred compensation is considered IRD when it passes into an estate, it is a viable candidate for a charitable bequest. However, due to the issues of vesting and taxation, plan participants have an ongoing concern as to whether the estate will be subject to tax when the deferred compensation is transferred. Fortunately for those who want to bequeath deferred compensation, the IRS has ruled that the IRC §691(a) status of deferred compensation enables a direct transfer to charity through a beneficiary designation.[14]

Charitable Trusts: Combining the Personal and the Philanthropic

Like charitable gift annuities, charitable remainder trusts (CRTs) and charitable lead trusts (CLTs) benefit both donor and charity. A remainder trust pays trust income to the donor for a period of time, then transfers the remaining assets to charity. A lead trust is just the opposite—it pays the trust income to charity for a period of time, then distributes the remaining assets to the donor or the donor's named beneficiaries. Each trust offers specific advantages, but they are both beneficial to those who wish to make a major gift with an immediate income tax deduction while continuing to enjoy personal benefits.

Charitable Remainder Trusts

A charitable remainder trust (CRT) is a good option for someone who wants to make a major gift but also needs to ensure an income for a number of years or for life. It's an irrevocable trust that pays the donor (or one or more designees) income from the trust for life (or joint lives) or for a period of up to 20 years, and at the end of the trust term, distributes the remaining trust assets to charity. The present value of the charitable remainder interest must be at least 10% of the initial value of the property transferred to the CRT.

It's possible for a donor to create a testamentary CRT and fund it with retirement assets. The donor names the trust as beneficiary of a retirement account and grants the trustee the power to use the distribution of retirement assets to purchase income-producing securities. A CRT is a tax-exempt trust, so there is no immediate income tax due on the distribution of the retirement assets.

Lincoln Community Foundation

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

Bonus Link:

Planned Giving Answers Online - A Technical Resource Library

The trustee must pay an annual income to the non-charitable beneficiaries for a certain period of time, typically for the lives of family members. These payments may either be a fixed dollar amount (Charitable Remainder Annuity Trust or "CRAT") or a specified percentage of trust assets as revalued every year (Charitable Remainder Unitrust or "CRUT"). CRUTs are more popular due to their flexibility. After the interest of the non-charitable beneficiaries terminates, the remaining assets are paid to the charitable beneficiaries.

There are many advantages to contributing retirement assets to a charitable remainder trust:

- It is easy to name a CRT as a beneficiary of a retirement plan or IRA
- Distributions of retirement assets to the CRT do not trigger immediate taxation
- The estate receives a charitable deduction for the value of the remainder interest to the charity
- The CRT pays a life income to trust beneficiaries and may be used to preserve assets in favor of selected beneficiaries (e.g., first to a spouse, then to children from a prior marriage)

Charitable Lead Trusts

A charitable lead trust (CLT) is an attractive option in our current low-interest-rate environment, and is good for people who wish to make a gift to charity and eventually pass the property to heirs in a tax-favored way. Like a CRT, the donor transfers assets into this irrevocable trust—typically marketable securities with strong growth potential, which will maximize the benefit for the remainder beneficiaries.

The trust exists for a set number of years or for the lifetime of an individual. During the trust term, the trust makes annual payments to charity. At the end of the trust term, the remaining assets pass to the donor's children or grandchildren (nonreversionary or family lead trust) or back to the donor (grantor lead trust).

How Interest Rates Affect Lead Trusts

When the applicable federal rate (AFR) is low, the calculated value of the charity's income interest is greater, which generates a higher charitable gift tax deduction for a grantor lead trust. Moreover, in a family lead trust, the value of the remainder going to heirs is lower, and this is the amount on which the transfer tax is based. The lower expected remainder results in lower estate tax. Many individuals with philanthropic goals choose CLTs today to pass wealth to loved ones while providing a charitable legacy.

Gifts of Life Insurance

Some people find that donating a paid-up life insurance policy makes sense from a tax perspective because it removes the policy from the future estate and generates a significant income tax deduction. Such a gift is eligible for an income tax charitable deduction, provided the policyowner transfers all rights of ownership to the charity.

LINCOLN COMMUNITY
FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

This gift involves a simple assignment and change of beneficiary form filed with the insurance company to name the charity as owner and beneficiary of the policy.

Alternatively, if an income tax charitable deduction is not critical, the donor may:

- Make the charity the beneficiary of a life insurance policy.
- Give other assets to charity and use the life insurance proceeds to replace, at death, the wealth that was contributed to charity during life.

Conclusion

Geoffrey Pyke [creator of the Habbakuk project] lived most of his life as if it was an experiment. The idea he wanted to test was simple enough: that he could solve any problem, and what's more, so could anyone else.[15]

Some clients experience charitable giving "problems"—they want to give to a meaningful cause or institution without creating financial hardship or greatly diminishing the inheritance they intend to leave to heirs. Luckily, this is a problem advisors can help their clients solve. By introducing philanthropically-minded clients to some of the many tools and techniques for charitable giving, advisors and clients can work together to find a gift that works best for everyone.

ENDNOTES

1 Pyke chose the name from what he supposed Voltaire had said regarding Habakkuk: "Il était capable de tout" ("he was capable of anything"). The misspelling of the name "Habbakuk" by Pyke's American secretary persists.

2 The percentage limitations are 50% of AGI for a cash gift and 30% of AGI for a gift of long-term appreciated property. Any deduction in excess of this limitation may be taken in up to five following tax years. The donor may make a special election to reduce the amount of the contribution by the appreciation in the property in order to be eligible for the 50% limitation, which could make sense if the appreciation is small or the donor needs a large deduction in the current year.

3 See, IRC §170, subsections (b)(1) and (d)(1).

4 See, the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act).

5 While there is no provision prohibiting transfers from Roth IRAs, there is no tax advantage either. QCDs cannot be made from employer-sponsored retirement arrangements such as a SIMPLE or SEP IRAs or 401(k) plans. A donor would first have to roll these amounts over into an IRA before making a QCD.

6 Donor Advised Funds (DAFs) and some supporting organizations are not options as qualified recipients.

7 See, IRC §1411. The additional 3.8% tax on net investment income is a concern for those with investment income and adjusted gross incomes higher than $200,000 (single) or $250,000 (married). It should also be noted that RMD income can affect the taxability of an individual's Social Security benefit.

8 Although the ultimate beneficiary can deduct that portion of the tax attributable to the estate tax on an individual tax return, heirs unfortunately often miss this deduction.

9 Keep in mind that since IRD passing to a surviving spouse falls under the unlimited marital deduction, this is preferable to leaving it to other beneficiaries. To the extent the surviving spouse does not exhaust the IRD assets during life, they will be taxable in the estate.

LINCOLN COMMUNITY FOUNDATION

215 Centennial Mall South
Suite 100
Lincoln, NE 68508
402.474.2345
402.476.8532 fax

www.lcf.org

Paula J. Metcalf
Vice President for Gift Planning and General Counsel
paulam@lcf.org

Scott Lawson
Vice President for Finance
scottl@lcf.org

Richard K. (Chip) DeBuse II
Vice President for Development
chipd@lcf.org

Tracy Edgerton
Vice President for Strategic Giving
tracye@lcf.org

Quick Links:

- Sometimes, Basic is Best
- Ramping Up Use of Retirement Assets
- Charitable Trusts: Combining the Personal and the Philanthropic
- Conclusion

Bonus Link:

Planned Giving Answers Online -
A Technical Resource Library

LINCOLN COMMUNITY FOUNDATION

Fall 2016

CHARITABLE GIVING

a resource for charitable gift planning professional advisors

10 Naming a charity as beneficiary used to raise undesirable RMD issues, since prior RMD rules provided no solution to the issue of assigning a "life expectancy" to a charitable organization. Final Treasury regulations allow account owners to determine RMDs under the Uniform Lifetime Table, regardless of the life expectancy of the designated beneficiary. This change encouraged more frequent designations of IRAs and retirement plan assets for charitable giving purposes.

11 See, e.g., Egelhoff v. Egelhoff 532 U.S. 141 (2001).

12 The federal estate tax exemption is $5.45 million in 2016.

13 Carefully consider the consequences of using distributions from a plan subject to IRC §409A for making charitable contributions. Under §409A, deferred compensation may only be paid out on the events permitted by §409A, such as disability, death, change in control, separation from service and unforeseeable emergency.

14 See, PLR 200002011, where the IRS ruled that the IRD status under IRC §691(a) of three separate types of nonqualified deferred compensation enabled each benefit to transfer directly to charity by way of a beneficiary designation. The IRS also reiterated that under IRC §2055, the deferred compensation was to be treated similarly to other IRD assets transferred to qualified charities at death, allowing the estate to make use of the estate tax charitable deduction.

15 Henry Hemming, Geoffrey Pyke—Inventor, Genius, Fugitive, Spy, www.inventricity.com