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Philanthropic Tax Planning for Family Members and Charities

Strategies for fat and skinny cat clients.

Conrad Teitell , Stefania Bartlett , Cara Howe Santoro | Nov 02, 2020

Last month, we wrote about recent changes to charitable giving—from the Setting Every Community Up for Retirement Enhancement Act to the Coronavirus Aid, Relief, and Economic Security Act—and how to make tax-advantageous gifts that directly benefit charities now. This month, we focus on transfers benefiting *both* family members *and* charities: how to plan outright lifetime charitable gifts so that the carryover for "excess" gifts doesn't die with the donor; charitable gift annuities (CGAs); charitable lead trusts (CLTs) (only for abdominous cats); and disclaimers benefiting both families and charities.

Carryovers

A 5-year carryover is allowed for most charitable gifts exceeding the various adjusted gross income (AGI) deductibility ceilings for the year.[1] But, when a donor shuffles off this mortal coil,[2] any remaining carryovers can't be carried over. It's a carryover, not a carryunder.

So, consider the type of ownership of assets contributed to charity by the elderly or by donors in poor health. Even though a married couple files a joint income tax return, the carryover from a donor spouse's charitable donations is lost after the year of that spouse's death. See "Election to Limit Deduction," this page.

Election to Limit Deduction

An often overlooked consideration

A donor may make an irrevocable election to limit her deduction for a contribution of long-term appreciated property to a public charity to her tax basis of the donated property. The income tax deduction is then increased from 30% to 50% of adjusted gross income. Because the carryover is lost at death—and it can't be inherited or bequeathed—this election should be made by the executor on a decedent's final income tax return. The decedent can't thank you, but her heirs will.[1]

— Conrad Teitell, Stefania L. Bartlett & Cara Howe Santoro

Endnote

1. *See* Conrad Teitell, Stefania L. Bartlett and Cara Howe Santoro, "Charitable Deductions for Gifts by Individuals, Partnerships and Corporations," *Trusts & Estates* (October 2018).

How to maximize a surviving spouse's income tax charitable deduction: If a married couple's property is held in the name of the spouse (the husband, for example) whose life expectancy is considerably shorter than the other spouse, he should give his spouse the assets he plans to contribute. For U.S. citizen spouses, the transfer qualifies for the unlimited gift tax marital deduction. For alien spouses, the transfer qualifies for the special annual $157,000 gift tax exclusion (updated annually for inflation). (Remember, there's a difference between an alien spouse and an alienated spouse. The latter may well be a U.S. citizen.) The spouse who's believed to be the survivor makes the charitable gifts. This donation allows the surviving spouse to make use of the charitable deduction carryover.

If it isn't clear which spouse the flying fickle finger of fate[3] will point to and will die first, the property to be contributed should be titled in both of the spouses' names. If one spouse dies after the joint property has been contributed to charity, the surviving spouse will benefit from half the remaining charitable deduction carryover—that is, the portion that's attributable to her half interest in the donated property.[4] The result is the same in community property states—half the carryover is the survivor's.

A decedent can give a survivor an income tax charitable deduction. Rather than making testamentary charitable gifts, a donor might consider an outright bequest to a cooperative spouse or other cooperative family member. The surviving spouse or family member then makes a gift to charity of all or part of her bequest. If she's an itemizer, she gets an income tax charitable deduction. If the spouse is the cooperative one, the decedent's estate would qualify for an estate tax marital deduction in the same amount the estate would have received with an estate tax charitable deduction. This allows the surviving spouse to benefit by getting an income tax charitable deduction. This shouldn't be required—or even mentioned—as a request, hope, desire or wish in lifetime or deathtime instruments, letters or emails. (This is best discussed in a motel room with the water running.)

Naturally, the would-be decedent has to have confidence that the surviving spouse or other family members will follow his wishes.

CGAs

An introduction by Jane Austen: "An annuity is a very serious business ... People always live forever when there is an annuity to be paid to them."[5] If she were writing *Pride and Prejudice* today, the novel's opening sentence would at its end have the words we've added in italics: "It is a truth universally acknowledged, that a single man in possession of a great fortune must be in want of a good wife"[6]*in poor health and an unused $11.58 million unified federal estate and gift tax exemption amount (indexed for inflation).*

A donor in a CGA contract irrevocably transfers money or property to a qualified charity in return for its promise to pay the donor, another individual or both, fixed and guaranteed payments for life. The value of the consideration the donor pays to the charity exceeds the actuarial value of the payments to be made by the charity to the annuitant(s). The excess is a charitable gift.

Payments may begin immediately under the most common CGA or may be deferred until a future time—more than one year from the transfer under a deferred payment gift annuity (DPGA).

In essence, the transfer for a CGA is part charitable gift and part purchase of an annuity.

The transferred assets become part of the charity's general assets, and the annuity payments are backed by all the charity's assets—not just the transferred property. This is an important difference between CGAs and charitable remainder unitrusts (CRUTs), charitable remainder annuity trusts (CRATs) and pooled income funds (PIFs), in which the obligation to make payments is limited to assets in those segregated planned gifts.

For a CGA, there must be donative intent and a donor who wants life income. Of all the planned giving arrangements, CGAs are the simplest and most popular. A typical CGA agreement is fairly short and easy to understand, making even novice donors comfortable with the arrangement. Under the agreement, the donor (and/or another annuitant) receives a guaranteed income stream for life. On the death of the surviving annuitant, the remaining assets (the residuum) are applied by the charity for its general use unless a specific purpose is specified in the agreement.

Charitable vs. commercial annuity. A donor can get higher payments by buying a commercial annuity. But, insurance companies don't fight disease, educate youngsters, feed the hungry or provide many other benefits people need. In addition:

- Selling appreciated property to buy a commercial annuity generates a capital gain of the difference between the property's basis and its fair market value (FMV). However, when transferring appreciated assets to a CGA, the gain is smaller and, in most cases, can be spread over the annuitant's life expectancy.
- For itemizers, the charitable deduction reduces the higher cost of a CGA instead of a commercial annuity.
- Unlike other planned gifts, CGAs can be funded with "difficult" assets and aren't subject to the private foundation self-dealing rules or penalties for unrelated business taxable income (UBTI). More about difficult assets later.
- Unlike the case with CRUTs, CRATs, PIFs and provisions in wills of living individuals, with a CGA, the charity can get immediate use of some of the gifted assets. The charity may spend a portion of the gifted assets if it meets all reserve requirements imposed by the state(s) where the charity may be registered. Or, it may hold the gifted assets in reserve until the death of the annuitant or, for CGAs for the benefit of a second annuitant, the death of the surviving annuitant.

CGA agreements. Here are some details:

Creation. CGAs are contracts and are governed by a written agreement between the donor and the issuing charity.

Some states require specific disclosure and other provisions. It's crucial to check state law before executing a CGA agreement. The agreement should be signed by both the donor(s) and the charity, although some states accept agreements without the donor's signature, provided the donor has signed an application form.

Don't overlook. The CGA may have to meet the requirements of not only the charity's state but also the law of the state of the donor's domicile. Some states also require that the law of the donor's state be the governing law in the agreement.

The charitable gift portion must be more than 10% of the CGA's creation. For CRUTs and CRATs, the gift portion (the remainder interest) must be a minimum of 10%.

Unlike CRUTs and CRATs, CGAs may not be for a term of years or more than two lives.

State regulation of CGAs. A number of states regulate CGAs by requiring charities issuing them to be licensed and/or file annual reports. In addition, some states specify minimum reserves and allowable investments. Further, some states also require specific disclosure language in CGA agreements.

The American Council on Gift Annuities (ACGA) provides detailed, state-by-state information on the applicability of licensing, reporting and disclosure requirements. The ACGA also publishes recommended maximum rates for both immediate and DPGAs (discussed below). Access this information at *www.acga-web.org*.

CGAs vs. CRATs. CGAs differ from CRATs in several ways. CRAT payments are made only as long as the trust has sufficient assets, while CGA payments are backed by all of the charity's assets.[7] Further, the capital gains implications, the way rates are set and the taxation of the annual payments also differ. For example, a CRAT's self-dealing and jeopardizing investment prohibitions don't apply to CGAs. Mortgaged property and S corporation (S corp) stock can be used to fund a CGA, but even though allowed, it may not be wise.

Itemizers' charitable deductions. For CGAs and DPGAs, the donor is entitled to income, gift and/or estate tax charitable deductions for the charitable contribution, calculated as the difference between the amount of money or the FMV of long-term securities or long-term real estate transferred and the present value of the annuity.[8] The present value of the annuity is based on the life expectancy(ies) of the annuitant(s), the frequency and timing of payments and the Internal Revenue Code Section 7520 rate effective at the time the CGA is entered into. The income tax charitable deduction is subject to the usual deductibility limitations (AGI ceilings and carryovers) of outright charitable gifts.[9] Planned giving software produced by several firms do the calculations.

Capital gains tax implications. The transfer of appreciated property for a gift annuity is deemed to be a bargain sale under Treasury Regulations Section 1.1011-2(a)(4). As a result, the donor will recognize capital gains when entering into a CGA agreement. Any gains recognized on the transfer is taxable to the donor at the time of transfer either as long-term or short-term capital gains (depending on the kind of property transferred and the donor's holding period).

However, the capital gains may often be reported ratably over the lifetime of the annuitant(s). In computing the amount of the gain, the basis of the transferred property is allocated between the gift portion and the actuarial value of the CGA. The amount of gain is the difference between the value of the CGA and the basis allocated to the value of the CGA.[10] The gain determined under the bargain sale rules is reportable by the donor-annuitant ratably over her life expectancy if: (1) the CGA is nonassignable (except it can be assigned to the issuing charity); and (2) the donor is the sole annuitant or is one of the annuitants in a two-life annuity.[11]

Income taxation of CGA payments. A percentage of each CGA payment is treated as a return of principal and is excludable (tax free) for the period of the annuitant's life expectancy under IRC Section 72. The percentage (called the "exclusion ratio") is determined when the CGA is created and remains constant.[12]

CGA funded with S corp stock. CGAs, unlike CRUTs and CRATs, may be funded with S corp stock because charities are eligible S corp shareholders. However, IRC Section 170(e)(1) requires that the charitable income tax deduction be reduced to reflect assets such as unrealized receivables, appreciated inventory and depreciation recapture, which would produce ordinary income on a sale. As to the charity, IRC Section 512(e)(1) treats all income attributable to S corps as UBTI, and gain on the sale of the stock is treated as UBTI.

Self-dealing and excess business holdings issues. CGAs may be a problem solver if you run into those problems for CRUTs and CRATs.[13]

DPGAs

A donor transfers money or property to a charity in exchange for its promise to pay an annuity to the donor, another or both, to begin more than one year from the date of the transfer. The donor is able to make a gift now and get an income tax charitable deduction when she's in a high tax bracket, deferring payment until those years when the donor may need the income more (for example, after retirement) and may be in a lower income tax bracket.

The charitable contribution is the amount of money, or FMV of long-term securities or long-term real estate transferred, less the actuarial value of the DPGA.

A DPGA's payments are determined by taking the amount transferred to the charity and compounding it annually at the interest rate, determined by an actuary, for the period until the annuity begins. That figure is then multiplied by the rate of return currently offered to donors who are now the age the donor will be at the "starting anniversary" date—the anniversary of the date of purchase (gift) that coincides with (or next precedes, if none coincides with) the due date of the first annuity payment.[14]

- **Taxation of annual payments.** The amount of each payment that'll be excludable, or tax free, depends on the effective rules when the payments start. A reasonable rule would be that the expected return (which is needed to compute the exclusion ratio and hence the excludable amount) is to be computed at the time payments begin, using the then-life expectancy tables.
- **Capital gains tax implications.** Treasury regulations, Revenue Ruling 72-438 and Rev.
- Rul. 84-162 are silent on the capital gains implications of DPGAs funded with appreciated property. An unpublished private letter ruling holds that the rules applicable to immediate CGAs apply to DPGAs. Thus, the gain will be determined under the bargain sale rules and will be reportable ratably over the annuitant's life expectancy if: (1) the annuity is nonassignable (except to the issuing charity); and (2) the donor is the sole annuitant in a one-life annuity or is one of the annuitants in a two-life annuity. The PLR holds that the gain won't be reportable until payments begin and then will be reported ratably over the life expectancy (determined as of the "starting anniversary" date). This is logical. In no event can the capital gains be greater than the return on the contract for the year.

CLATs

This is an especially opportune time for individuals who are "wealthy" (defined below in the gift and estate tax context) and charitably minded to create charitable lead annuity trusts (CLATs). That's because of the confluence of historically low IRC Section 7520 rates (as of November, 0.4%), decreased market values in some cases and the gift and estate tax definition of "wealthy."

The wealthy are a changing target. For this article, they're individuals who are subject to the combined 40% gift and estate tax (currently only estates valued over $11.58 million (double that for a married couple)).

Starting in 2026, however, when the current tax law reverts to the combined gift and estate tax exemption under earlier laws, the wealthy will be those with an estate of over $5 million (adjusted for inflation). Twice that for a married couple.

But wait, a poorer definition of "wealthy" could emerge sooner than 2026. With federal deficits now ballooning, Congress could well decrease the combined gift and estate tax exemption before 2026. And some pundits say, depending on the results of the 2020 election, the combined gift and estate tax exemption could revert to $3.5 million of yesteryear ($7 million for a married couple).

Who creates a CLAT? An individual who wants to benefit a charity up front and make a gift to family members down the road at greatly reduced—or no—gift or estate tax cost. The value of the family members' remainder interest is reduced by the value of the charity's lead interest.

The charity's lead interest in an inter vivos CLAT qualifies for the IRC Section 2522(c)(2)(B) gift tax charitable deduction as well as the IRC Section 2055(e)(2)(B) estate tax charitable deduction.

Gift of the noncharitable (family) remainder interest. This gift by the donor to the family member remainder takers is valued at the time the trust is created. It's the amount transferred to the trust reduced by the value of the charity's lead interest.

Grantor vs. non-grantor. There are two types of inter vivos CLATs:

- **Non-grantor CLAT (virtually all of them).** The donor isn't entitled to an income tax charitable deduction. Technically, the non-grantor CLAT's subject to the provisions of part I, subchapter J of chapter 1 of subtitle A of the IRC and is allowed a deduction under IRC Section 642(c)(1) in determining its taxable income for any amount of gross income paid for purposes specified in Section 170(c).
- **Grantor CLAT.** The donor may be entitled to an income tax charitable deduction, but the "price" is that she'll be taxed on the income paid to the charity.[15] Technically, with a grantor CLAT, the donor is treated as the owner of the entire CLAT under subpart E, part I of subchapter J, chapter 1, subtitle A of the IRC. This type of trust is rarely created and isn't discussed in this article.
- **Permissible term**. Payments may be to the charity (or charities) for a specified term of years. There's no 20-year cap, as there is for CRUTs and CRATs. But, check the rule against perpetuities under governing state law.

CLAT measured by a life or lives—limitations. As an alternative to a term-of-years CLAT, the trust instrument may provide for payment of the annuity amount for the life or lives of an individual or individuals. However, only one or more of the following individuals may be used as measuring lives: the donor, the donor's spouse and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in Sections 170, 2055 or 2522) is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. A trust will satisfy the requirement that each measuring life is a lineal ancestor (or the spouse of a lineal ancestor) of all non-charitable remainder beneficiaries if there's a less than a 15% probability at the time of the contribution to the trust that individuals who aren't lineal descendants of an individual who's a measuring life will receive any trust principal. The probability must be computed under the applicable tables in Treas. Regs. Section 20.2031-7.[16] Each individual used as a measuring life for the annuity period must be living on the date assets are transferred to the trust.[17]

Why these detailed restrictions on the lives that can be used to measure the trust term? It's the IRS' response to the so-called "ghoul lead trust"—the donor used the measuring life of an individual who was at death's door. The family members would get the remainder interest much earlier because the individual whose life measured the trust term was expected to die way before the end of his actuarial life expectancy. But, the value of the charity's lead interest for purposes of computing the gift tax charitable deduction was based on his actuarial (not actual) life expectancy. So, this short-lived scheme promised the best of all worlds (except for the sick guy who was the measuring life): an inflated gift tax charitable deduction making the actuarial value of the family member's remainder interest much smaller, and the family members got their remainder interests much earlier than if they had to wait until the death of an individual who had a normal life expectancy.

More rules:

- **Payment requirements.** CLATs aren't subject to minimum or maximum payout requirements. Thus there aren't 5% minimum and 50% maximum payment requirements as there are for CRUTs and CRATs. Those trusts have a 10% minimum remainder interest requirement. There isn't a comparable CLAT requirement.
- **The annuity payments may be made in cash or in kind.** If the trustee distributes appreciated property in satisfaction of the required annuity payment, the trust will realize capital gains on the assets distributed to satisfy part or all of the annuity payment. The trust will be allowed a Section 642(c)(1) deduction for the realized capital gains.[18]
- **Generation-skipping transfer (GST) tax.** If a CLAT has or may have a skip person, as defined in IRC Section 2613(a), as a remainder beneficiary, the transfer to the trust will be subject to the GST tax. Under IRC Section 2651(f)(3), a charitable organization is deemed to be in the same generation as the

CLT's donor. As a result, the GST potential of a CLT depends on whether any noncharitable beneficiary is a skip person.

- **No additions to CLATs.** For purposes of qualification under the IRS' safe-harbor revenue procedure (described below), the trust must contain a provision that prohibits additional contributions. A CLAT that permits—or doesn't specifically prohibit—additional contributions won't qualify for safe-harbor treatment.[19]

The ability to add to a CLAT can, in effect, be achieved by creating an additional separate trust.

Although additional contributions aren't allowable for CRATs, we believe there's no policy reason for prohibiting additions to CLATs. But, we wouldn't fight the IRS on this.

Basis considerations. Remainderpersons get a carryover basis for assets received from an inter vivos CLAT.[20] Heirs get a stepped-up basis (equal to the estate tax value) for assets received from a testamentary CLAT.[21]

Safe-harbor help. The IRS, in 2007, issued specimen inter vivos (nongrantor and grantor) CLATs and testamentary CLATs,[22] which are extremely helpful, as are the numerous alternative provisions and instructive annotations. But, of course, don't follow any specimen trust blindly. Modify and add your own provisions to meet the needs of each situation.

The arithmetic: Why now's an especially good time for charitably minded individuals to create CLATs.

Example:[23] Suppose a donor (grantor) in November 2020 transfers $1 million to a 10-year CLAT and sets the annual annuity payment at $102,213, which at a historically low 0.4% Section 7520 rate is the annuity necessary to make the actuarial value of the CLAT interest equal to $1 million. The donor makes no taxable gift to the family remainder takers because the actuarial value of the family's remainder is zero.

Any amount of total return (income plus appreciation) during the 10-year trust term in excess of 0.4% will pass to family members at the end of the term completely free of gift or estate tax. If the trust earns just 3% total return annually over the trust term, there will be $172,159 left for family, and if the total return is higher, even more will be left for the family after 10 years:

Total return	Amount left at trust termination in 10 years
3%	$172,159
4%	$253,064
5%	$343,270
6%	$443,599
7%	$554,931
8%	$678,210
9%	$814,449
10%	$964,730

Note: The November Section 7520 rate of 0.4% can be used for CLATs created in November, December or January.[24]

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Disclaimer Planning

Testamentary documents can provide for charities by using disclaimers. For example:

The testamentary document could name an alternative beneficiary: If my daughter disclaims her bequest, the property shall pass to XYZ college.

The testamentary document could provide that if a beneficiary disclaims, the property passes to the charities named under my residuary clause.

Caveat. The individual who disclaims can't just name the recipient of the property she wishes to benefit from her disclaimer. The individual who named the potential disclaimant as the beneficiary must have specified who gets the bequest if the bequest is disclaimed. For example, a decedent could provide that any part of a bequest disclaimed by Family
Member X goes to Charity Y. Not only does this benefit the charity, but also the decedent's estate will qualify for the estate tax charitable deduction if a proper qualified disclaimer is made.

Be mindful. The disclaimer requirements vary by state, and it's essential that they be complete and perfected under local law. Also, for federal estate tax purposes, these requirements must be met for the estate tax charitable deduction: A written refusal must be received by the decedent's representative (for example, executor) within nine months of the transfer or bequest (generally the date of death). The disclaimant can't accept any benefits from the property—for example, income. But, it's okay when a spouse disclaims and gets the property, without her direction, in a different way under another provision of the will or through intestacy law.[25]

Parting Lesson

We conclude with a tale (perhaps apocryphal) of how estate taxes were saved by a lawyer who knew more than just the tax law.

A Connecticut town founded in 1640 had no brothel until 1990. Harold, a community leader, organized a citizen's committee and shut it down.

The following year, the madam died and left her entire $2 million estate to Harold, stating, "This bequest is in recognition of the many wonderful nights we spent together."

Terribly embarrassed, Harold asked his lawyer what he should do. "Disclaim the bequest," said his lawyer.

Harold: "But, but $2 million is a lot of money."

Lawyer: "After taxes, you'll get only $1.3 million."

Harold: "That's still a lot of money."

Lawyer: "Trust me—disclaim."

Harold disclaimed. The lawyer then brought an action on Harold's behalf against the madam's estate for testamentary libel.

Harold won a $2 million verdict against her estate—tax free.[26]

Endnotes

1. Conrad Teitell, Stefania L. Bartlett and Cara Howe Santoro, "Charitable Deductions for Gifts by Individuals, Partnerships and Corporations," *Trusts & Estates* (October 2018).

2. When one has "shuffled off this mortal coil" is to die, as used in Shakespeare's "to be or not to be" soliloquy in Hamlet.

3. From the comedy television program Rowan & Martin's Laugh-In hosted by comedians Dan Rowan and Dick Martin.

4. Treasury Regulations Section 1.170A-10(d)(4)(iii).

5. Jane Austen, *Sense and Sensibility* (Leipzig 1964), at p. 8.

6. Jane Austen, *Pride and Prejudice* (London 1918), at p. 1.

7. For more information on charitable remainder trusts, see Conrad Teitell, Patricia R. Beauregard and Stefania L. Bartlett, "Patching Up Mucked Up CRTs," *Trusts & Estates* (August 2015) and Conrad Teitell,

Heather J. Rhoades and Daniel P. Fitzgerald, “Charitable Remainder Pitfalls,” *Trusts & Estates* (October 2015).

8. Treas. Regs. Sections 1.170A-1(d), 20.2055-2(f) and 25.2522(c)-3(d).

9. *See* Conrad Teitell, Stefania L. Bartlett and Cara Howe Santoro, *supra* note 1.

10. Treas. Regs. Section 1.1011-2(a)(4)(c) Example 8.1.

11. Treas. Regs. Section 1.1011-2(a)(4).

12. Treas. Regs. Section 1.72-4 et seq.

13. Note that charitable gift annuities (CGAs) funded with remainder interests in personal residences and mortgaged property and a charity’s re-insuring CGAs are all beyond the scope of this article. For a discussion of these, other CGA topics and a 16-point drafting checklist, *see* Conrad Teitell, *Deferred Giving: Explanation, Specimen Agreements, Forms* (Taxwise Giving 1997).

14. *See* American Council on Gift Annuities’ website for its recommended maximum rates for both immediate and deferred payment gift annuities, *www.acga-web.org* .

15. Internal Revenue Code Section 170(f)(2)(B).

16. Treas. Regs. Sections 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

17. *Ibid.*

18. Revenue Ruling 83-7.

19. *See* Private Letter Ruling 8213127 (Dec. 31, 1981).

20. IRC Section 1015(b).

21. IRC Section 1014(a).

22. Revenue Procedures 2007-45 (inter vivos) and 2007-46 (testamentary).

23. This example and analysis are by Lawrence Katzenstein, a nationally recognized estate and charitable planning lawyer, writer and lecturer. He’s a partner in Thompson Coburn and resident in the firm’s St. Louis office. Larry is the creator of Tiger Tables software (*tigertables.com*), which computes the tax consequences of all types of charitable and other estate plans.

24. Treas. Regs. Section 25.7520-2(a)(2).

25. Treas. Regs. Section 25.2518-2(e)(2).

26. Prior to 1996, libel awards weren’t taxable. The Small Business Job Protection Act of 1996 added the word “physical” to the clause “on account of personal physical injuries or physical sickness” found in IRC Section 104(a)(2).

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