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## ESTATE PLANNING AND CHARITABLE GIVING

**By James A. Harris**

### 1. Basic Structure of Estate and Gift Taxes

Estate and gift taxes under the Internal Revenue Code ("the Code") form a unified scheme to tax the cumulative amount of wealth transferred by an individual during life and at death. Transfers of property to a spouse or to charity, however, generally are excluded in calculating estate and gift tax liability. Under present law, there is a cumulative exemption of \$625,000 for gifts to recipients other than a charity or spouse. Gifts above this lifetime cumulative exemption are taxed at rates from 37 percent to as much as 55 percent.

During life, an individual can make annual gifts of \$10,000 to any one recipient without any tax consequence. Acting jointly, a husband and wife may give \$20,000 per year tax-free. (After 1997, the annual exclusion will be indexed for inflation, in the same manner that income tax rates and personal exemptions are indexed.) Gifts in excess of these amounts, however, count against the lifetime exemption and must be reported on annual gift tax returns. If lifetime gifts use up this exemption, gift taxes become payable at the same rates as property passing at death.

At the time of an individual's death, taxable gifts during lifetime (in excess of the annual exclusion of \$10,000) are added to the value of property passing at death, with a credit allowed for any gift taxes paid during life to prevent double taxation of lifetime gifts. This assures that the cumulative transfer of wealth is taxed at the appropriate graduated rate and that the lifetime exemption is used only once.

Under these wealth transfer taxes, an individual presently can transfer to recipients other than a spouse or charity up to \$650,000 of property, during life or at death, without imposition of any tax. Likewise, a married couple can presently transfer up to \$1.25 million of property free of federal gift and estate taxes, provided that the transfers are structured and coordinated to take full advantage of the \$650,000 exemption each is allowed.

These cumulative exemption amounts are scheduled to increase significantly over the next seven years, which will substantially increase the amounts a married couple can pass free of federal estate and gift taxes:

<u>Year</u>	<u>Exemption (Individual)</u>	<u>Exemption (Joint)</u>
2000-2001	\$ 675,000	\$1,350,000
2002-2003	\$ 700,000	\$1,400,000
2004	\$ 850,000	\$1,700,000
2005	\$ 950,000	\$1,900,000
2006 and thereafter	\$1,000,000	\$2,000,000

Thus, gifts to a spouse and gifts to charity can be an important and useful estate planning technique.

## 2. Tax Considerations of Charitable Gifts

At present, combined federal and state individual income tax rates can top 45 percent for regular income and 33 percent for capital gains. Cumulative lifetime gifts and transfers at death in excess of \$600,000 are taxed at an initial rate of 37 percent and can go as high as 55 percent. Gifts to charity, however, receive favorable income, estate and gift tax treatment:

- \* Donors may deduct charitable contributions in determining their individual income tax liabilities.
- \* Gifts to charity during life are fully exempt from federal gift tax.

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- \* Gifts to charity at death likewise are fully exempt from federal estate tax.
- \* The charitable deduction rules are very technical and complex for almost anything other than a simple gift of cash, so all such gifts should be carefully planned with the donor's tax advisors.

### 3. Alternative Forms of Charitable Giving

There are many ways other than traditional cash contributions through which individuals can help a charitable organization build an endowment fund. Set forth below are some of the more common alternatives:

#### a. Gifts Under Wills

A bequest to charity under a will can be expressed in several ways:

- \* A specific sum of money to charity;
- \* A percentage of the total estate; or
- \* A percentage of the residuary (the amount left after expenses, taxes and other gifts);

Charitable gifts by a husband and wife can be deferred until the second death, where appropriate.

Testamentary gifts are simple: they often can be accomplished by an amendment, called a codicil, to the donor's existing will.

#### b. Gifts of Appreciated Property

- \* Give appreciated property, like stocks and bonds, to charity instead of selling it.
- \* There is no capital gains tax, which could be as much as 33 percent (federal and state) if the property were sold.

- \* The individual can deduct the gift as a charitable contribution, generating a combined federal and state tax benefit of as much as 45 percent of the value of the property.

c. Charitable Remainder Trusts

- \* The basic structure involves an irrevocable trust with an immediate interest to a non-charitable beneficiary or beneficiaries and the balance at the end ("the remainder") passing to charity.
- \* The non-charitable gift can be for a fixed term (up to 20 years), for a single life or for multiple lives.
- \* The non-charitable interest can be retained by the donor or given to a third party (like a child).
- \* Tax considerations of charitable remainder trusts:
  - ° The donor can take an income tax charitable contribution for part of the value of the property transferred to the trust. The deduction is equal to the actuarial value of the remainder interest passing to charity, i.e., the present value of the charity's right to receive the property in the future.
  - ° At death, only the actuarial value of any continuing non-charitable interest is subject to estate tax; the remainder passing to charity is a deductible charitable contribution.
  - ° The non-charitable lead interest could be subject to gift tax if given to a third party.
  - ° The charitable remainder trust is exempt from income tax except to the extent it has "unrelated business income," i.e., income from operating a trade or business or from leveraged investment property.

° Distributions from a charitable remainder trust reflect in the recipient's hands their tax character in the trust's hands, in the following order:

- # Current, then accumulated ordinary income;
- # Current, then accumulated capital gain;
- # Current, then accumulated tax exempt income;
- # Nontaxable principal.

Thus, current distributions from a charitable remainder trust generally will be fully subject to income tax.

\* Under a charitable remainder trust, the non-charitable interest must be expressed one of two ways:

° As a fixed sum of money per year, not less than 5% of the initial value of the trust property. This alternative is called a "Charitable Remainder Annuity Trust."

° As a fixed percentage, not less than 5%, of the value of the trust property as determined annually. This alternative is called a "Charitable Remainder Unitrust."

\* An annuity trust provides a guaranteed benefit, together with protection against diminution in value due to a deflationary economy or poor investment performance by the trust.

\* A unitrust, because the payout is determined annually, allows the non-charitable interest to share in the trust's investment performance. With proper investment, a unitrust thus provides protection against inflation and passes through some of the benefit of favorable investment performance.

\* A unitrust is more flexible than an annuity trust:

° Additional contributions can be made to a unitrust but not to an annuity trust.

- Under a unitrust, the current payout can be limited to the lesser of the defined unitrust percentage or the trust's actual income. This is called an "income only" unitrust. The unitrust can, but does not have to, allow make-up in later years when trust income exceeds the unitrust amount.
- \* An income only unitrust enables a donor to accomplish a number of non-tax, non-charitable goals, such as:
  - Accumulating savings free of tax to provide supplemental retirement income.
  - Distributing funds saved for the college education of a child without the immediate income tax burden from selling the assets, and, possibly, reducing the total income tax burden by having the income taxed at the child's lower rate.
  - Avoiding adverse income tax treatment on certain kinds of investment assets, like debt securities with taxable original issue discount or market discount.
- \* Recently, there have been indications the IRS may believe that the use of income only unitrusts for such non-tax financial purposes could be abusive. Informed observers reject this conclusion, characterizing the IRS concerns as an erroneous conclusion in search of an unavailable legal theory. Nevertheless, increased IRS scrutiny in this area suggests more conservative planning in the use of income only unitrusts for the time being.
- d. Remainder Interest in a Farm or Personal Residence
- \* An individual can give a remainder interest in a farm or a personal residence to charity and deduct the actuarial value of the remainder interest as a charitable contribution for income tax purposes. At the donor's death, the gift will not be subject to estate tax because it passes to charity.

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- \* The remainder interest can be following joint lives, for example, a husband and wife.
- \* A personal residence is either the donor's principal residence or a second residence such as a vacation home.

e. Life Insurance

- \* A donor can designate a charity as the beneficiary of a life insurance policy. There are no tax benefits to such a gift, however:
  - ° Because the donor still owns the policy, he cannot deduct ongoing premium payments.
  - ° Because the donor still owns the policy, the proceeds are includible in his gross estate for federal tax purposes at death, but the estate can deduct the proceeds because they pass to charity.
- \* A donor also can transfer ownership of the policy to the charity itself, in which case there are some tax benefits:
  - ° The donor can deduct the cash surrender value of the policy for income tax purposes, as well as any premiums he continues to pay.
  - ° Because the charity owns the policy, the proceeds are not includible in the donor's gross estate for federal tax purposes at death. (There would be no adverse estate tax result had the donor owned the policy at death because proceeds payable to charity are fully deductible.)
- \* Generally, it is more advantageous to use life insurance to generate additional wealth in order to free other assets for charity:
  - ° By giving a life insurance policy to an irrevocable trust, or contributing funds to an irrevocable trust to purchase a life insurance policy, a donor can generate a large amount of money that will pass to non-charitable beneficiaries (i.e., the children) at

the donor's death, without any significant income, estate or gift tax consequences.

- With the non-charitable interests adequately provided for, the donor then can give to charity the property he or she otherwise would have left to his or her spouse, children, etc. And such charitable gifts will be fully deductible for federal estate tax purposes.

Knowledgeable insurance agents are able to help donors plan charitable gifts through use of life insurance.

#### 4. Using Retirement Benefits for Charitable Gifts

Today many Americans have large amounts of retirement savings in tax-qualified retirement plans -- company plans, 401k plans, Keogh plans, IRAs and the like. When an individual dies with a large accumulation, a beneficiary who is neither a spouse nor a charity can be left with a tax burden that consumes most of the gift:

- \* Unpaid retirement benefits at death are part of a decedent's taxable wealth when passing to a beneficiary other than a surviving spouse or charity. (In contrast, benefits paid to a surviving spouse or charity are deductible.)
- \* Retirement benefits that were accumulated free of income tax during an individual's life are subject to income tax, whether received by the individual or by his heirs. (Such benefits also are free of income tax in the hands of a charitable beneficiary but are taxable to a surviving spouse.)

Even though the estate taxes attributable to retirement funds passing at death are deductible for income tax purposes, the combined effect of estate and income taxes can leave the beneficiary with less than one-quarter of the original accumulation.

An individual contemplating large charitable gifts at death should carefully review the assets from which such a gift might be paid. Retirement benefits

pass to a charity pass free of income or estate. An individual can achieve a significant tax savings by designating a charity as beneficiary of tax-deferred retirement benefits when compared to paying a charitable gift of the same amount out of other assets and leaving the retirement benefits to a non-charitable beneficiary.

5. Conclusion

There are a number of other, more exotic and complex ways to support charity up to any including forming one's own charity to carry out his or her charitable goals during life and even after death. Any individual desiring to support charity can find an appropriate and effective way to do so consistent with his or her financial means while in many cases achieving favorable tax benefits.

Individuals interested in considering charitable gifts other than simple cash donations should consult their own advisors.