

# charitable contributions

Your ability to control when and how you make charitable contributions can lower your income tax bill, effectively reducing the actual cost of any gift you make, while fulfilling your philanthropic objectives.



## BASIC PLANNING IDEAS

You can save substantial taxes by simply:

- Using long-term appreciated property to fund your charitable contributions.
- Timing your contributions so that they are made in a year when your tax bracket will be higher.

More sophisticated planning techniques are discussed in this chapter, including using donor-advised funds, private foundations, and charitable trusts, to help you combine tax planning with your charitable goals.

For 2016, the benefit of the charitable contribution deduction may be reduced due to the itemized deduction limitation ("Pease" provision) that applies when AGI exceeds \$259,400 (\$311,300 for joint filers). For 2017, the thresholds increase to \$261,500 (\$313,800 for joint filers). Your itemized deduction limitation will be the lesser of (a) 3% of AGI above the applicable amount, or (b) 80% of the amount of the itemized deductions. Other limitations also apply (see Chart 6). Therefore, careful planning must be done to determine the true tax benefit of charitable contributions being considered. Multi-year income tax projections should be included as part of the charitable planning process.

## USE LONG-TERM APPRECIATED PROPERTY

You should always use appreciated publicly traded securities that you have held for more than one year, rather than cash, to fund significant charitable contributions. You should also consider using other eligible appreciated property, such as artwork, that you can give to a museum. By doing so, you can get the double tax benefit of receiving a deduction equal to the full fair market value of the security or property (as if you contributed cash) and avoid paying capital gains tax on the appreciation (see Tax Tip 18).

There are limitations on the amount of contributions that you can deduct in a given year based on your AGI, as Chart 6 indicates. While a contribution of long-term appreciated property is generally limited to 30% of your AGI rather than the 50% limit that applies to cash, this is still usually a high ceiling and any disallowed contributions can be carried forward for the next 5 years.

## TIME YOUR CONTRIBUTIONS

Always consider your tax rate for this year and future years before deciding when to make your contributions. Your tax rate may vary significantly in a year of unusual financial events, but more common is the impact that the AMT will have on your contributions. If possible, make your charitable contributions in a year that you are not likely to be in the AMT. In 2016, the difference between the maximum regular tax rate of 39.6% and the AMT rate of 28% is 11.6%.

If you expect your maximum tax rate to be the same next year, pre-pay your charitable contributions this year (if feasible and desired) to gain the advantage of accelerating the tax deduction.

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## THE BENEFIT OF CONTRIBUTING LONG-TERM APPRECIATED SECURITIES RATHER THAN CASH

A stock that you have owned for many years has appreciated to \$100,000 from its original purchase price of \$60,000. You have decided that it may have very little future growth potential. Instead of selling the stock, you donate it to your favorite charity. Your tax savings by donating the stock rather than cash would be:

	Cash Donation from Proceeds	Stock Donation
Tax savings on contribution (\$100,000 at 39.6% in 2016)	\$ 39,600	\$ 39,600
Capital gains tax if stock was sold (\$40,000 at 23.8%*in 2016)	(9,520)	0
<b>Net federal tax savings</b>	<b>\$ 30,080</b>	<b>\$ 39,600</b>

\*Includes 3.8% Medicare Contribution Tax on net investment income.

The year that you can take the deduction is the year the charity actually receives the property. Therefore, make sure that you satisfy the legal transfer requirements for contributions of securities or other property that you make prior to year-end. One way to do this is by having the securities transferred directly from your brokerage account to the charity's brokerage account before year-end, thereby accelerating the process.

## CONTRIBUTIONS DEDUCTIBLE ONLY AT COST RATHER THAN FAIR MARKET VALUE

Certain types of property will not avail you of a charitable deduction equal to the appreciated fair market value of the property. So, before contributing property, consider its eligibility and other options available to fund your charitable contributions. These types of property include:

### Securities held for 12 months or less

If you contribute securities that you have held for 12 months or less, your charitable deduction is equal to the lesser of the fair market value or your basis in the stock. Therefore, you lose the deduction for any of the appreciation of the security.

### Securities with a fair market value less than your cost

Never use these securities to fund your contributions since your deduction will be limited to the lower fair market value of the stock and you will permanently lose the benefit that you would have received had you sold these securities at a capital loss.

### Other ordinary income property

The charitable deduction for ordinary income property is limited to the lesser of the fair market value or your basis in the property, even if you have held the property more than 12 months. Ordinary income property includes inventory items and property subject to depreciation recapture.

### Tangible personal property

To get the property's full fair market value as a deduction, the appreciated property must qualify for long-term capital gain treatment had it been sold and the charitable organization must use this property in its exempt function (such as a painting given to a museum). Otherwise, your deduction will be limited to the lesser of your basis or the property's fair market value. Furthermore, if the charitable organization disposes of the property within 3 years, the donor will be required to include as ordinary income for the year of the disposition the difference between the charitable deduction and the donor's basis. However, if the organization certifies to the IRS, in writing, that the property's use was, or was intended to be, related to its exempt purpose or function, this rule would not apply.

### Vehicles

If the charitable organization does not use the vehicle in its exempt function, but instead sells the vehicle (for over \$500), your charitable deduction will be limited to the gross proceeds received from the sale by the charity, not the appraised value.

### Fractional interest

A fractional interest contribution consists of a gift of an undivided portion of property to a charity that uses the property in connection with its exempt purposes (e.g., an interest in artwork that is contributed to a museum). In this situation, your initial charitable deduction will be the fair market value of the property multiplied by the fractional interest contributed.

As an example, let's say you donate the use of a painting valued at \$400,000 to a museum for 3 months and you retain the painting for the remaining 9 months. Your charitable deduction would be \$100,000 based on 25% of the value of the painting at the time of the contribution (3 months of the year). If you gift the use of the same painting next year for 6 months (additional 3 months or additional 25%) and the fair market value of the painting has increased to \$440,000, your contribution would not be \$110,000 based on 25% of additional contribution multiplied by the value of the painting when contributed. Instead, it would be \$100,000 since a subsequent fractional interest donation of the same property is limited to the lesser of the value at the time of the initial fractional contribution or the value on the additional contribution date.

Beware that "recapture" will occur if you make an initial fractional contribution of artwork, then fail to contribute all of your remaining interest in the artwork to the same donee on or before the earlier of the date that's 10 years from the initial fractional contribution or the date of your demise ("specified period"). Recapture consists of an income inclusion in the year in which the specified period falls and is in the amount that was previously deducted plus interest running from the due date of the return for the year of the deduction until paid and a penalty of 10% of the amount of the income inclusion.

### Remainder Interest in Real Property

The owner of real estate, such as a vacation home, can have full use of the property throughout his or her life and leave a remainder interest to a charitable organization. You will receive a charitable deduction based on the present value of the remainder interest in the property in the year that the remainder interest is contractually conveyed, not when the charity actually takes title to the property. Therefore, you receive a current deduction even though the charity does not receive the property until the condition of the conveyance occurs (death of the donor).

### Conservation Easement

A conservation easement is a contribution of a real property interest to a charitable organization that uses the easement exclusively for conservation purposes. A real property interest for this purpose includes a perpetual restriction on the use of the real property. The donor does not give up ownership, control, or enjoyment of the land. The easement only restricts what can be done on or to the land. In the typical case, a perpetual conservation easement is given to a qualified conservation organization. The charitable deduction is equal to the difference in the fair market value of the property with and without the easement and requires a qualified appraisal. This type of charitable contribution often gives the IRS cause to scrutinize the valuation on which the deduction is based.

Under a temporary provision that had terminated for contributions made in taxable years beginning after December 31, 2014, the 30% contribution base limitation on deductions or capital gain property by individuals did not apply to 'qualified conservation contributions.' Rather, the 50% contribution base limitation and 5-year carryover applies. PATH reinstated and made permanent these provisions.

### Unreimbursed expenses

Although you cannot get a charitable deduction for services performed on behalf of a charitable organization, you may deduct incidental unreimbursed expenses incurred while performing these services. Travel expenses to and from the place where the services are performed are deductible. You can deduct expenses of operating your car including tolls and parking fees but not expenses connected with maintenance of the car such as depreciation, repairs or car insurance. Alternatively, you can deduct 14¢ per mile. Reasonable expenses for meals and lodging while "away from home" in performing charitable services are deductible as well. Expenses that are considered personal and not specifically incurred in the performance of services on behalf of a charitable organization are not deductible.

## IRA DISTRIBUTIONS AS CHARITABLE CONTRIBUTIONS

The provision for qualified charitable distributions, which allows IRA and inherited IRA owners age 70½ or older to transfer portions of their accounts to qualifying charities tax-free while satisfying all or a portion of their required minimum distributions, has been made permanent as a result of PATH.

According to the provision, if you are age 70½ or older, you can make tax-free distributions to charity from an IRA of up to \$100,000 per year. These distributions must be made directly to the charity and are neither includible as income nor deductible as an itemized deduction on your tax returns.

In order to qualify, the charitable distribution must be made to a public charity. Payments to a donor-advised fund, supporting organization or private foundation do not qualify.

This technique has additional benefits since, unlike a taxable distribution, the distribution is not included in AGI. This may therefore impact the Medicare Contribution Tax on net investment income, the 3% reduction of itemized deductions, and the limitation of personal exemptions.

## HOW TO ACCELERATE THE TAX BENEFIT OF FUTURE CONTRIBUTIONS AND MEET PHILANTHROPIC GOALS

Certain charitable vehicles allow you to accelerate the tax benefit of future contributions into the current year while retaining practical control over when such contributions are actually made to your intended charity. The most common charitable planning vehicles include:

- Donor-Advised Funds
- Private Foundations
- Charitable Trusts

## DONOR-ADVISED FUNDS VS. PRIVATE FOUNDATIONS

Contributing to either a donor-advised fund or a private foundation offers a tax deduction (subject to different limitations), but they have their differences. The donor-advised fund is the simpler and less costly alternative. Using a private foundation requires you to create a legal entity with annual tax filings, subject to an excise tax on net investment income and other potential excise taxes (see the discussion below). Yet, despite these disadvantages, the private foundation can still be a preferable alternative if substantial amounts are involved, so consider the following similarities and differences when evaluating either of these options:

### Obtain a large charitable deduction in the current year

Both a donor-advised fund and a private foundation allow you the ability to avoid paying capital gains tax on appreciated marketable securities held more than one year when such property is donated. However, a private foundation is subject to an excise tax of 2% on its net investment income, including capital gains on the appreciated property you contributed. The excise tax can be reduced to 1% depending on the foundation's level of granting in a given year. An income tax will be assessed on a foundation's unrelated business

income as well as an onerous excise tax if the foundation is involved in various acts of self-dealing or other prohibited transactions.

### **Retain control of the timing, amount and payment of future charitable contributions**

The donor-advised fund permits you to make your contributions to a public charity that will retain them in an account (which can bear your name) for future charitable distributions. Typically, the fund will follow your charitable preferences, though it is not legally obligated to do so. The private foundation generally gives you more direct control, which can sometimes make it easier to achieve your investment goals and ensure that your charitable objectives are accomplished.

### **Maintain management control of the private foundation's investments**

This can be one of the major advantages of the private foundation. You retain full control over all investment decisions, allowing you to use your investment expertise and resources to maximize the assets in the foundation.

### **Involve family members**

A private foundation can provide intangible benefits by involving family members in a collaborative philanthropic effort. Your family can benefit from having the responsibility of making management decisions and formulating a mission statement to satisfy the family's overall charitable desires. The management responsibilities of the foundation can be passed down from one generation to another, perpetually keeping it in your family's name. It is also possible to give your children the ability to recommend charitable distributions for your donor-advised fund.

### **Make minimum distributions**

A private foundation is subject to a rule which requires an annual distribution to charities equal to at least 5% of the average value of its assets. Excise taxes will be assessed on foundations that fail to distribute the required minimum distribution. Typically, although not always, the actual earnings and appreciation of the assets in the foundation are greater than the 5% minimum distribution. Donor-advised funds do not have a minimum grant distributions rule.

## **CHARITABLE TRUSTS**

A charitable trust can provide the following benefits:

- Convert appreciated property into an annuity.
- Diversify your portfolio and defer capital gains tax.
- Obtain a current-year charitable deduction for the present value of a remainder interest left to charities by using a charitable remainder trust. However, with the present low interest rate environment, this deduction is lower than in the past.
- Pass appreciation on to your beneficiaries by using a charitable lead trust.

There are two types of charitable trusts — charitable remainder trusts ("CRTs") and charitable lead trusts ("CLTs"). You can set up either as an annuity trust or a unitrust. The annuity trust pays a fixed dollar annuity that is based on a fixed percentage of the initial trust value. The unitrust pays an annuity that will vary since it is based

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### **USE A CRAT TO DIVERSIFY YOUR PORTFOLIO AND PROVIDE YOU WITH AN ANNUITY**

As an original shareholder in a company that went public, you now own stock that is worth \$1,000,000 with a tax basis of only \$400,000. You would like to diversify your portfolio but you have been reluctant to do so because of the capital gains tax.

One option you might want to consider is establishing a charitable remainder annuity trust ("CRAT"). By doing so, you can combine your desire to diversify your portfolio with your charitable giving intentions. The trust can sell the stock and pay no tax on the \$600,000 gain at the time of the sale since the trust is a nontaxable entity. The trust can then use the proceeds from the sale to purchase other investments which, in turn, diversifies your overall portfolio allocation since you retain an annuity interest in the trust.

Assuming you choose a 10% payout rate, you will receive an annuity of \$100,000 for the term of the trust, much of which will be eligible for the net long-term capital gains tax rate of 23.8% (inclusive of the Medicare Contribution Tax on net investment income) based on the undistributed gain of \$600,000. You will also receive a current-year charitable contribution for the present value of the remainder interest going to charities. Remember, though, that the family loses the remainder value since it will pass to charities at the end of the trust's term.

on a fixed percentage of the trust's annual fair market value, which necessitates annual valuations.

## CHARITABLE REMAINDER TRUSTS

A CRT can help you diversify your portfolio and increase your annual income stream while satisfying charitable desires (see Tax Tip 19). If you contribute highly appreciated securities to a CRT, such as a concentrated position in low basis stock, the CRT can sell them without incurring a current capital gains tax. You will not only diversify your portfolio and reduce market risk, but you will also receive an annuity based on the securities' fair market value. You will be taxed as you receive annuity payments, as discussed below. The annuity you receive will probably exceed the income you are currently receiving from the contributed securities (but you will be foregoing future appreciation in excess of the annuity).

The CRT's assets grow tax-deferred because it is not subject to tax and you only pay tax on the annuity payouts as you receive them. Therefore, the CRT can immediately sell the appreciated stock that you contributed and spread out the tax on the gain over the life of the annuity (you may never actually pay the full tax). The taxable nature of the annuity is based on the trust's undistributed accumulated income at year-end, subject to the ordering rules. The assets remaining at the end of the trust's term go to your designated charities.

You can choose to have the annuity paid to your beneficiaries instead of yourself, but you must consider gift tax consequences since you will have made a gift to your beneficiaries equal to the annuity's present value. The gift amount is set at the date of the transfer to the CRT. Typically, this may result in lower overall gift and estate taxes if the IRS tables used for determining the present value of the annuity payouts are at a rate that is lower than the actual growth rate experienced by the CRT. You can also reduce overall family income taxes if the beneficiary's tax rates are lower than your tax rates.

chart

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## CHARITABLE CONTRIBUTION LIMITATIONS BASED ON ADJUSTED GROSS INCOME

The maximum deduction you are allowed for your charitable contributions is subject to a limitation based on your AGI, as noted below. However, see the discussion above and notes below for ways to increase some of the limitation amounts. To the extent that your deduction is limited, you can carry the disallowed contributions forward for 5 years, subject to the same annual percentage limitations.

Contributions Made To	AGI Limitation	
	Cash and Ordinary Property Income	Appreciated Capital Gain Property
Public Charities*	50%	30%
Nonoperating Private Foundations	30%	20%
Private Operating Foundations**	50%	30%

These ceiling amounts can be increased in the following ways:

- If a nonoperating private foundation makes qualifying distributions out of its corpus within 2½ months after the end of its taxable year equal to 100% of the contributions it received during that year, the 30% limitation for cash and ordinary income property increases to 50% and the 20% limitation for appreciated capital gain property increases to 30%.
- The 30% limitation for appreciated capital gain property donated to public charities and private operating foundations can be increased to 50% by electing to reduce your contribution to the property's cost. This is only advisable if your contributions would otherwise be limited and it is unlikely that you will benefit from the carryover in the future.

\*Donor-advised funds are treated as public charities.

\*\*Private operating foundations are nonpublicly supported organizations that devote most of their earnings and assets to the conduct of their own tax-exempt purposes.

To qualify as a CRT, the trust must satisfy the following rules:

- The term of the trust cannot exceed 20 years and the trust must be irrevocable.
- The annual annuity income payout to the beneficiary must be at least 5%, but not greater than 50% of either the initial amount transferred to an annuity trust or the annual year-end fair market value of the assets for a unitrust.
- The value of the remainder interest to the charity must be at least 10% of the trust's initial fair market value.

## CHARITABLE LEAD TRUSTS

The CLT is basically the reverse of the CRT. The annuity is paid to the charity and you or your beneficiaries receive the remainder interest at the end of the trust's term. But the income tax implications are complex because you are only allowed a charitable deduction if the CLT is structured as a grantor trust (with you reporting the annual income and charitable deduction). If the trust is set up as a non-grantor trust, you don't receive a charitable deduction but you are also not taxed on the income the trust earns.

Despite these complexities, a CLT can be an effective gift and estate tax planning tool because you are subject to gift tax only on the present value of the remainder interest you are giving away. This allows you to gift a much greater interest in assets, such as stock in an early stage company, and pay little or no gift taxes. If the stock value grows significantly, your beneficiaries will enjoy the excess appreciation since the growth will be greater than the earnings rate in the IRS tables for valuing the present value of the remainder interest, which has recently been very low. However, they will have to wait until the trust term ends in order to receive the remaining assets.

## SUBSTANTIATE YOUR CASH CHARITABLE CONTRIBUTIONS

Regardless of the amount of the contribution, cash donations to charitable organizations must be substantiated with a bank record or written communication from the donee organization showing the name of the donee organization, the date the contribution was made, the amount of the contribution and the value of any benefit to you. Therefore, you must make sure to obtain the necessary documentation to support your cash charitable donations. A cancelled check is no longer sufficient substantiation if the contribution is \$250 or more. The written acknowledgement must explicitly state whether any goods or services were received in connection

with the donation. This rule eliminates your ability to deduct weekly cash contributions made at religious gatherings unless you can meet the substantiation rules.

## NONCASH CONTRIBUTION APPRAISAL REQUIREMENTS AND LIMITATIONS

If you contribute property worth more than \$5,000, you are required to obtain a qualified appraisal. Also, you must complete and attach Form 8283, Noncash Charitable Contributions Appraisal Summary, to your tax return. This form must include the qualified appraiser's signature, and an authorized person from the charitable organization must complete, sign and date the appropriate section of the form, indicating the date of the contribution and whether the property is being used for the charity's exempt purpose.

A complete copy of the signed appraisal must be attached to your tax return if you contribute any of the following:

- Artwork appraised at \$20,000 or more.
- Any item, or group of similar items, for which you are claiming a charitable deduction greater than \$500,000.
- Easements on buildings in historic districts.

**Caution:** *A qualified appraisal must meet certain criteria to be acceptable:*

- *The appraisal must be made not earlier than 60 days before the date you contribute the property and before the due date (including extensions) of your tax return on which the deduction is claimed.*
- *The appraiser must be an individual who has either earned an appraisal designation from a recognized professional appraisal organization, has met certain minimum education and experience requirements, regularly prepares appraisals for which he or she is paid, or demonstrates verifiable education and experience in valuing the type of property being appraised.*

Contributions of similar items of property with an aggregate value exceeding \$5,000 are subject to the same requirements. For example, if you contribute clothing valued at \$3,000 to one charity and your spouse contributes clothing valued at \$2,500 to another charity, you would need to obtain qualified appraisals for both contributions. The appraisal requirements do not apply to contributions of cash, publicly traded securities or non-publicly traded stock worth less than \$10,000.

If these requirements are not satisfied, no charitable deduction is allowed, even if the charity received the property and the value is not in dispute.

**Medicare Contribution Tax on net investment income**

Charitable gifts are not deductible for purpose of calculating 3.8% Medicare Contribution Tax on net investment income of high income taxpayers.