

Rethinking How To Give

So much is changing, planners can help potential donors adjust

The next few years will see tremendous change in the world of philanthropic planning. Non-profit entities, as well as the financial and estate-planning communities that serve them, will have to work to adapt to a number of important trends:

- the aging of the U.S. population;
- continued uncertainty in the financial markets;
- proposed and actual changes in estate, gift, and income tax laws; and
- a growing need for greater cooperation between charities and

donors' advisors.

Already, each of these trends is having an impact independently. But they also interact in subtle and complex ways that present opportunities for creative charitable planning that benefits individuals and their charitable interests alike.

Recent discussions on the future of social security have brought the implications of an aging U.S. population into sharp focus. As a society, we are increasingly aware of the fact that nearly 25 percent of the current population will reach the age of 70 during the next 20 years, joining a large contingent of those already in that age range. (See "Live Births in the United States," p. CGS 6.)

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As the donors, who in recent decades were the backbone of support for non-profits move into their retirement years, fundraisers will necessarily begin to place even greater emphasis on gifts from older people. This trend has already begun. During the past 10 years, fundraising activities aimed at the needs of older donors increased dramatically. Bequest income realized, towards higher education, reached 26 percent of gifts from individuals for 2004, the highest percentage in decades.¹

This jump took place despite an overall lull in charitable giving. While total charitable giving in the United States grew at a rapid pace during the mid to late 1990s, in recent years, it has been relatively flat—apparently a result of fluctuations in investment markets and slower economic growth. (See "Charitable Giving Totals," p. CGS 7.) After all, gifts of appreciated stocks and other non-cash assets comprised some 24 percent of charitable giving in America in 2002.²

The lack of sustained growth in investment values continues to put pressure on asset-based giving, especially from the ranks of the wealthy. Lower interest rates also are affecting the amount of charitable gifts and the manner in which they are made. The 70-plus years are when many people realign their investments to produce more spendable (and in some cases donatable) income. But lower interest rates have reduced the ability of many older donors to give the amounts they would otherwise like to donate. As a result, many seniors are increasingly interested in ways to give, that also serve to increase their incomes.

In addition to the aging of the donor population and prevailing economic conditions, there are the ongoing changes to the nation's estate and gift tax laws—along with proposed changes to income tax rules. The impact on charitable giving is palpable.

There has been enormous speculation about how reducing and/or eventually eliminating the federal estate tax might affect charitable giving. Some observers claim lower estate taxes that raise the after-tax cost of making an estate gift will lead to a reduction of demand for such gifts. But there are studies purporting

to show that the lack of estate taxes would mean more disposable assets in estates—and therefore the wealthy may actually increase the amount they leave to charities.³

Another factor that could influence charitable giving is that many wealthy people do not yet realize that while the federal estate tax may go away, there'd still be a gift tax on lifetime transfers. The wealthy still will want to find ways to transfer assets during their lives without incurring the gift tax. As a result, planning tools that meet this need—such as the charitable lead trust—can be expected to hold greater appeal for some philanthropically inclined individuals and their advisors.

And that's just the estate and gift tax. Policy planners in Washington are also examining ways to simplify the nation's income tax system. One proposal that appears to have substantial backing is a "flat tax" that would allow deductions only for charitable gifts and mortgage interest. If the law moves in this direction, towards what's known as the "McTax," charitable planning would focus more on the income, capital gains and gift tax implications of charitable giving. Other proposals would, among other things, limit gifts of appreciated assets to cost basis for all property other than publicly traded securities.

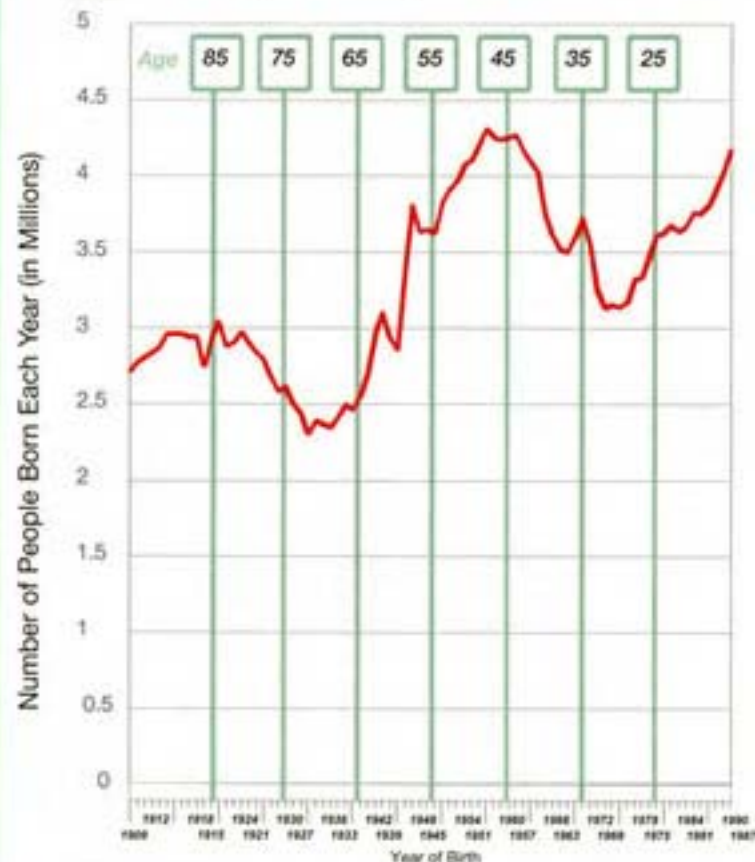
Clearly, times are changing. And this will require greater cooperation between donors, their advisors and representatives of charitable interests.

The need is already here. The oldest of the emerging generation of seniors is just now approaching the age of 70, with the leading edge of the baby boomers approaching 60. These mature individuals should begin contemplating plans for the eventual distribution of their property. But, given the increasing life span, this group is now relatively young from the perspective of philanthropic planning. Today, a 70-year-old couple has a combined life expectancy of some 20 years. For their tax-planning purposes, this is a long time for them to take advantage of charitable remainder trust's income, capital gains, gift and estate tax leverage. But for a charity, 20 years is a long time to wait for the CRT's benefit—especially when the donor may have made this gift as an

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LIVE BIRTHS IN THE UNITED STATES

Nearly 25 percent of the current population will reach age 70 during the next 20 years



Source: U.S. Census Bureau

alternative to an outright gift to an urgent capital funding effort.

Thus, the interests of donors and their charities may be diverging somewhat, and this friction may increase in coming years. Planners must work to help avoid unnecessary conflict. There are many ways that meaningful charitable gifts can be structured to provide substantial benefits to donors—without unduly diminishing their value to the eventual charitable recipient.

We might accomplish this goal in part by taking a fresh look at the planning tools at our disposal and learning to use them in new ways. Some plans that have enjoyed wide use in recent years may no longer

serve as well. But, with slight variations they may continue to be useful.

Consider, for example, the charitable remainder unitrust (CRUT) funded with appreciated assets for the lifetime of one or more people. This plan was very popular in times of rapidly increasing investment markets and relatively high interest rates. Typically, the trust was structured to pay the income beneficiaries 5 percent or more of the value of the trust assets each year with growth in the trust (and consequently the income) over time. But these trusts were often based on assumptions of total returns of 8 percent to 10 percent or even more. The initial income tax savings as

well as all or part of the income each year was in many cases used to fund the purchase of life insurance designed to replace, for heirs, the amount donated to the trust.

Today, after years of mixed results in equity markets and lower prevailing interest rates, there's a good reason to question whether such CRUTs will perform as expected over time.

As an alternative, consider a fixed payment charitable remainder annuity trust (CRAT) for a period of years. This approach allows for much more definite planning for cash flow needed to purchase insurance or for other purposes. A term-of-years trust is also more attractive to the ultimate charitable remainder recipient, which then can make more definite plans for the amount it ultimately will receive, and when the gift will be received.

For example consider a 55-year-old couple with \$1 million in securities with a cost basis of \$250,000 that yields just 1 percent in annual income. If the two fund a 5 percent CRUT for life with an anticipated total return of 8 percent, they will enjoy an immediate income tax deduction of \$233,000 and payments for life that should increase over time. They also will avoid capital gains tax at the time of their gift, and any amounts remaining in the trust beyond what is necessary to make their payments, will accumulate tax-free. But the charity will receive nothing while the pair are alive, and their anticipated life expectancy is 35 years.

On the other hand, suppose the couple used the \$1 million in securities to fund a CRAT that made fixed payments of 10 percent, or \$100,000 a year for 10 years. They would still enjoy an immediate income tax deduction of \$200,000. But instead of an uncertain income for life beginning at \$50,000 a year, they would receive fixed payments

totaling \$1 million over a 10-year period. If the trust assets are invested for a total return of 8 percent the charity can expect to receive \$710,000 in 10 years, rather than the remainder of the unitrust in 35 years. This plan may be more attractive to potential donors, particularly those who could use a larger flow of fixed income for the 10 years leading up to their retirement. This is especially important between age 55 to retirement age, because in these years many baby boomers will face the cost of paying for their children's college educations at the same time that they may be caring for older parents. If a donor is so inclined, the ability to put more funds into an insurance policy sooner may make the CRAT a more attractive option for funding a wealth replacement policy as well.

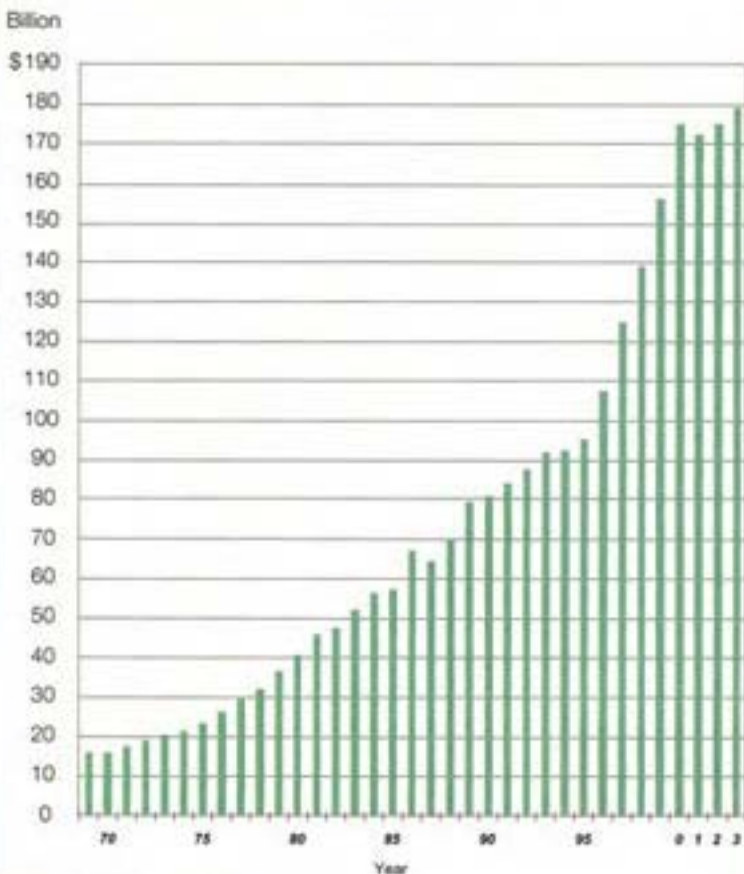
This example highlights how gifts can be structured for younger donors in ways that meet their needs, while also providing a meaningful gift when their charitable interests need it.

For younger donors, another option might be the use of charitable remainder trusts or gift annuities for the life of their parents or other, older loved ones, as a cost-effective way to provide support for their aging parents while still making a gift to charity. This plan makes use of a younger person's assets coupled with the life expectancy of older payment recipients. Once again, there is a current income tax deduction—which may be of great interest to donors if there's a flat tax that allows deductions only for charitable gifts and mortgage interest.

For middle-aged and older persons of wealth, the use of charitable lead trusts to fund gifts to charity over a period of time may become increasingly interesting. Recall that while the estate tax may be repealed, the gift tax will remain. The lead

CHARITABLE GIVING TOTALS

Charitable giving by individuals in the United States grew at a rapid pace during the mid-to-late 1990s, but has remained relatively flat in recent years



Source: Giving USA 2004

trust is a way to make valuable gifts to charity while reducing or eliminating the impact of the gift tax.

And what of donors who are already in their retirement years? Lower returns on investments and less anticipation of growth in asset values may lead to greater interest in charitable gift annuities and CRATs that offer fixed income for the remainder of their lifetimes. At advanced ages, it's possible to set very attractive payment rates—without undue risk of corpus exhaustion.

Seniors who are required to take mandatory withdrawals from retirement plans that are in excess of what they require for living

expenses may wish to make gifts of these amounts to charity, creating a "wash" for tax purposes in many cases, whether or not Congress ever enacts the much-anticipated CARE act that would make such gifts without reporting the withdrawal for income tax purposes.

Older donors who might have been considering a bequest from what will now be a non-taxable estate may choose to accelerate their gift in ways that serve to increase their income for the rest of their lives, while providing a generous income tax deduction in lieu of estate tax savings that will no longer be relevant to their planning.

Charities typically encourage and welcome such gifts as they provide useable funds in relatively short periods of time.

For those considering bequests and other gifts that will be completed at death, the elimination of the estate tax for a vast majority of Americans has already occurred and is not likely to be reinstated. This results in more freedom to plan bequests in ways that may not have qualified for tax deductions in the past. One example is intervening income interests to others in trusts that would no longer have to qualify for estate tax deductions.

Gifts of amounts remaining in retirement plans will still be a preferred way to leave funds at death because, even without a federal estate tax, these funds will be taxed as income in respect to a decedent (IRD) and are best left to charity while leaving other assets to heirs. When family members are other-

wise provided for, some donors also may wish to redirect to charitable interests, all or a portion of their life insurance proceeds that had been expected to pay estate taxes.

Hopefully Congress will soon reach a consensus on the future of the estate, gift, and income tax. In the meantime, the U.S. population continues to age and the need for estate planning—charitable and otherwise—will increase unabated. There remain many opportunities for donors, their charitable interests, and their advisors to work together as a team to help achieve multiple planning objectives. ■

Endnotes

1. *2004 Voluntary Support of Education*, (Council for Aid to Education, New York, 2005).
2. *Chronicle of Philanthropy*, April 14, 2005.
3. Paul G. Schervish and John J. Havens, *Extended Report on Wealth With Responsibility Study*, Boston College Social Welfare Research Institute, (Boston, 2001).

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