

# Philanthropy In Uncertain Times

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**Is charitable giving societal “fluff” that exists only during times of prosperity, or is it something that is resistant to the economic downturns that periodically affect the for-profit sector?**

**T**hroughout its history, an important factor in American life has been the vital role charities and philanthropic institutions have played in an economic, political and cultural mix that includes business, government and private philanthropy.

In challenging economic times, much of the public's focus is put on the health of the business sector. The continued existence of government is not seriously questioned, as taxing power assures its survival as long as business activity continues. Governments continue even in the worst of economic times. But what of the nonprofit sector? How does this sector fare during difficult economic times? Is it societal “fluff” that exists only during times of prosperity, or is it something that is resistant to the economic downturns that periodically affect the for-profit sector?

Our system of taxation is designed to result in the involuntary redistribution of wealth to a certain degree via progressive income, gift and estate taxes. The system is also designed, however, to recognize and to some extent subsidize an alternative system of voluntary wealth redistribution via the nonprofit sector. That is the underlying rationale for the chari-

table deduction from income, gift and estate taxes. There are, however, limits to the voluntary redistribution of income represented by the caps on the amount of charitable gifts that can be deducted for purposes of determining taxable income. These limits are currently 50 percent of adjusted gross income (AGI) for gifts of cash and the 30 percent of AGI limitation for gifts of property. The original charitable deduction introduced in 1917 was limited to 20 percent of AGI, so over the years lawmakers have seen fit to expand the amount of income one can divert

to charitable purposes on a tax-free basis.<sup>1</sup>

No limit applies to the amount of wealth that can be devoted to charitable purposes through the estate. If desired, one can devote an entire lifetime's accumulation of wealth to the support of educational, religious, charitable, cultural and other activities and in so doing completely bypass estate taxes that would otherwise be due.

As a result of changes in attitudes in America over the past 20 years, we have increasingly come to rely on the nonprofit sector, and funds that are voluntarily directed there for philanthropic purposes, to meet needs that would otherwise be met by government or business, or not at all. Likewise in both western Europe and the re-emerging economies of eastern Europe, there appears to be a trend toward more reliance on



certain social ends being accomplished with funds voluntarily donated to nonprofits/NGOs.

What does history teach us about charitable giving in times of economic distress? Note that in almost every year for the past 32 years, giving by individuals in America has increased. The most recently reported results for 2000 indicate that over \$150 billion was voluntarily donated by individuals to America's nonprofits.<sup>2</sup> The only exception was 1987 when equity markets lost 20 percent or more of their value in a period of days. Even then, charitable giving dropped less than 5 percent. See Chart 1.<sup>3</sup>

Americans have consistently shifted the ways they make their gifts during times of economic slowdown. During the Great Depression of the 1930s the historical record indicates that overall giving in America dropped somewhat at the onset of economic hard times, but then grew steadily through the mid to late 1930s before rapidly accelerating during and following

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World War II. See Chart 2.<sup>4</sup>

Other evidence indicates that Americans shifted the ways they made their gifts during the Depression years. The *New York Times* reported on April 3, 1939 that giving to higher education, especially to the leading institutions of

the time, held steady or actually *increased* during the Depression. Excerpts from an article entitled "Gifts to Colleges Hold During Slump" shed light on the predominant form of gifts during that time period:

"A survey of gifts and bequests to 49 American colleges and universities since 1930 indicated yesterday that gift receipts declined only 2.3 percent for the nine years from 1930 to 1938, compared with the nine previous years of prosperity.

The survey, made by the John Price Jones Corporation, showed a trend toward a concentration of gifts to fewer and larger institutions. Four of them received more money during the depression years than in the years of prosperity, while other colleges and universities received much less. Although [outright] gifts showed a decrease in depression years, the amount of bequests showed a sharp increase."

— *NYT*, April 3, 1939.<sup>5</sup>

History reveals, therefore, that during times of economic distress, charitable giving in America typically continues, although increases may come primarily in the form of bequests and other testamentary gifts. These methods of giving were actively encouraged during the period from 1900 to 1930. One example of organized planned gift development efforts from that time comes from the annual report of Baldwin Wallace College published in 1910. In a section devoted to requesting support for the College, it is stated:

Whoever would like to support the annuity plan of the college with a larger gift should apply to the president for more information. In this plan, the donor himself receives the interest on his gift as long as he lives - a good plan for those who need the interest to support themselves. Whoever would like to remember the college with a bequest of either a larger or a smaller sum should use the following form:<sup>6</sup>

Over the years, bequests, gift annuities, charitable trusts and similar plans have proven to represent particularly resilient means of making charitable gifts as they appear to be much less sensitive

to both short and long-term spikes and dips in the economy and may be seen as a way to hedge fund development efforts against hard times. In fact, these methods of giving far predate our current civilization. Note the excerpt from a treatise entitled *A History of Trusts and Charitable Foundations*:

“Long before the practice of making Wills and Testments had developed, the leaving of property in perpetuity to other than paternal heirs was encouraged in both Egypt and Chaldea and was implicit in early Judaism. The Greeks first developed a concept of a “living legal heir” to whom property could be given in perpetuity during a person’s life with the consent of his natural heirs. In the first century B.C., the Roman law modified this concept so that associations were considered as “sentient reasonable beings” and “immutable undying persons,” and by the first century A.D. were permitted to receive bequests.”<sup>7</sup>

### Understanding Current Trends

One of the keys to understanding trends in philanthropy in uncertain economic times is to consider the “anatomy” of a charitable gift. Each gift has five parts - “who” makes it?, “why” do they make it?, “what” do they give?, “when” do they give it?, and “how” is the gift structured? Most charitable gifts are made immediately in the form of cash and represent a portion of



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the discretionary dollars that may currently reside in a checking account. Some who have been fortunate enough to enjoy gains from investments may choose to fund their gifts using property that has increased in value since it has been owned. Our tax laws in effect encourage this type of gift, as the lack of a “sale or exchange” results in avoidance of capital gain that would otherwise be due.

There have always been times when, for a variety of economic and personal reasons, donors will turn to somewhat more sophisticated means of completing their gifts using a variety of tools such as trusts, annuity contracts, insur-

ance and other so-called “split interest” gifts. These gifts, along with bequests via wills and trusts are sometimes collectively referred to as “planned gifts.”

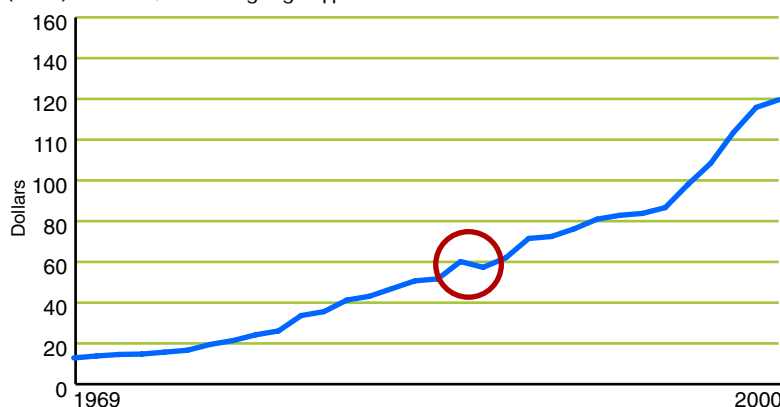
During tougher economic times, more persons appear to be interested in planning gifts in ways that allow them to maintain income and/or access to principal if needed. This is perhaps one explanation for the previously referenced growth of philanthropy via estate gifts during the Depression years.

Since the 1930s, however, we have developed a much broader array of gift vehicles to help persons with the means and inclination to “vote with their dollars” during more difficult economic times. Because many of these alternative gift techniques involve the use of trusts, annuities, insurance and similar vehicles, it is essential that the estate and financial planning community be sensitive to their use, as clients may increasingly be turning to these means to fund their gifts. For example, one major medical research institution that is now embarking on a \$1 billion funding effort is projecting that some \$400 million of that amount will come in the form of realized bequests and irrevocable trusts, gift annuities and other deferred gifts completed during the campaign. This is not uncommon in today’s environment.

### CHART 1

#### Giving By Living Individuals In America 1969-2000

Total charitable giving has increased steadily in the last 32 years. The only exception was 1987 (circled). Even then, charitable giving dropped less than 5%.



Source: Giving USA.

### The Most Attractive Vehicles

While many planned gifts will continue to be completed through the use of charitable remainder trusts, gift annuities and other traditional planning tools, other gift planning vehicles may now offer special advantages for charitable entities and those who wish to support them. As returns on equities and interest rates fluctuate over time, they create various climates that are more or less conducive to various types of gift planning vehicles.

One of the more attractive means of making larger charitable gifts in today’s environment, for example, is through the use of the charitable lead trust. The lead trust holds spe-

cial attraction in times when donors may be less comfortable with the idea of irrevocably transferring large amounts of their accumulated wealth for charitable use. In times when less wealth is being created, philanthropically inclined persons may be more interested in preserving what they have for the eventual benefit of their loved ones. The lead trust offers a way to accomplish both goals.

While “new” to some planners, the roots of the charitable lead trust can be traced to statutes enacted in England in the 16th century. Quoting from the aforementioned treatise on the history of charitable trusts:

“During the reign of Henry VIII, further restraints were placed on the creation of trusts for religious purposes with the enactment in 1531-32 of a statute that reiterated the Mortmain doctrine denying [religious] corporations the right to hold land without license, and prohibited the creation of trusts for religious uses of more than 20 years. Thus, the whole weight of the law as well as of policy was exerted to mold the charities of England to secular ends and to assist donors in creating the great charitable institutions which were so profoundly to alter the structure of the English society.”<sup>8</sup>

Trusts similar in form to modern day charitable lead trusts were thus utilized as exceptions to legal prohibitions against the perpetual transfer of property for religious purposes.

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The economic environment today favors charitable lead trusts in ways that have not been seen since the 1970s. This plan was extremely popular during that time period. A 1977 Columbia Law Review article entitled “A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance,” prominently featured the charitable lead trust as a primary tool for use in reducing or totally eliminating the impact of the estate tax.<sup>9</sup>

### Floating Rates

This was the case because prior to 1983 the discount rate used to determine the present value of

the charitable interest represented by payments from a lead trust was set at an artificially low 6 percent. That rate was raised to 10 percent in 1983, effectively crippling the use of charitable lead trusts. In 1989, the current system of causing the discount rate to “float” with the federal midterm funds rate caused the rate to increase to as high as 11.6 percent in May, 1989. In a remarkable shift over the past decade, the statutory discount rate has fallen to 4.8 percent as recently as December, 2001. The rate for February, 2002 was 5.6 percent, lower than it was during the prime years for charitable lead trusts in the 1970s.

In addition to taking advantage of a favorable interest rate environment, the charitable lead trust offers an effective way to “leverage” the increases in gift and estate tax exemption amounts that became effective January 1, 2002. This can be especially true for those who wish to make significant charitable gifts while not depriving younger heirs of an eventual inheritance.

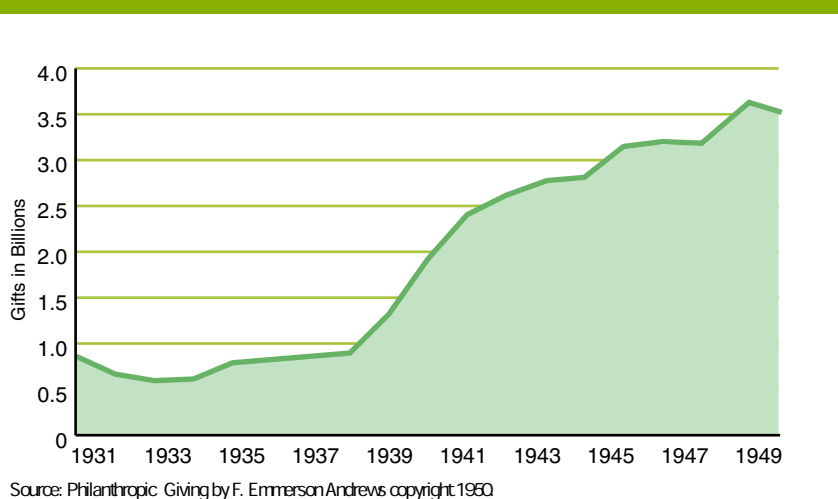
**Example:** Barbara and Harold are both age 55. Barbara recently inherited \$5 million from her mother. She and her siblings each inherited that amount. Her mother’s estate was in the range of \$25 million and taxes amounting to several million dollars were paid at her death. Needless to say, Barbara is pleased to learn that Congress passed legislation in 2001, that may eventually result in her estate not being subject to this tax again at her death. She and her husband have already accumulated a significant amount of wealth and they have used all of the exemption amount available to them under the pre-2001 tax act law.

Barbara and Harold are pleased to learn that they are now each entitled to make an additional \$325,000 in tax-free gifts as the gift and estate tax exemption amount rose to \$1 million on January 1, 2002.

Barbara and Harold had a daughter who died at the age of 12. They would like to make a significant gift in her memory to fund

**Chart 2**

### Estimated Gift Totals 1931-1949



research and treatment of the disease that took her life. They have two other children, ages 24 and 26. Neither of them has yet found gainful employment and Barbara and Harold are worried that they may have been given too much too soon.

Barbara and Harold have been urged to consider creating a private foundation as part of their long-range financial planning. They are reluctant to transfer large sums irrevocably at this time as they are uncertain whether estate taxes will continue to be a consideration. As an interim step, one of their advisors suggested that a good way to make use of the additional \$325,000 they have available in estate tax exemption beginning in 2002 is through the use of a charitable lead trust.

They are pleased to learn that they can place \$2 million, about 20 percent of their net worth, into charitable lead trusts that will pay 6.8 percent to a fund for cancer research for 15 years. This will result in a gift stream of \$1,020,000 from each of them over 15 years, a total gift between them of \$2,040,000.

Barbara and Harold file gift tax returns and report gifts of \$1 million each in the form of the lead trust remainders to their children. Because of the intervening income interest to charity, the charitable gift tax deduction is \$675,090 each, leaving \$324,100 taxable to each, which is almost exactly the amount of the \$325,000 additional exemption to which they are entitled beginning January 1, 2002.

Through wise planning, they have each made a significant gift to fund research for a 15 year period, while they have used the lead trust to increase the amount they could give to their children from \$325,000 each in the form of an outright gift which they don't want them to have today, to a \$1 million gift they will receive in 15 years after they have had the chance to become self sufficient. Each child is told that, barring special circumstances, they will receive no more assistance from their parents for the next 15 years.



**D**uring recent years, leading institutions including Cornell University and others, have pioneered a concept variously known as Virtual Endowments, Flexible Endowments, Flex Endowments, or other similar appellations.

The children could receive the trust corpus tax free in ten years if the payout was increased to 8.88 percent. Barbara and Harold are pleased that their children will receive this portion of their inheritance at a time that is appropriate without the payment of estate taxes, regardless of whether the planned elimination of the estate tax actually occurs.

### **Creating a Permanent Endowment**

Is there a way to also create a permanent endowment using the charitable lead trust? If the charitable recipient of the lead trust payments in the above example devoted half of the lead income interest each year for research purposes and placed the remaining amount in a perpetual endowment fund in memory of the daughter, a significant endowment would remain at the time of the termination of the lead trust.

*Note:* from the perspective of the trustee of the trust, it will manage a \$2 million trust for 15 years and a \$1.5 million endowment trust which remains to be managed following the termination of the lead trust.

### **A Temporary Private Foundation?**

Suppose in the example above that Barbara and Harold had wished to transfer \$10 million

to their children tax free. The term and payout referred to above would not be sufficient to accomplish that result. They could, however, change the payout rate to 7.5 percent for a period of 25 years. Their children would receive their inheritance tax free in their early 50s and gifts totaling \$18,750,000 would be made to charitable interests during the time the trust was in existence.

In some cases, people like Barbara and Harold may be advised to create perpetual private foundations and allow their children to draw salaries to serve as managers, in lieu of payment of 50 percent or more in estate taxes. While that can be good advice, consider how a wealthy couple might respond when told there was a way to achieve the avoidance of the estate tax without permanently depriving their children of their wealth! The lead trust can be seen as a vehicle that in essence accomplishes that result. What if the 7.5 percent return is not achieved? Some of the corpus will be distributed to charity in satisfaction of the annuity payments and the family may receive somewhat less. But what corpus does the family ultimately receive in the case of a private foundation? None.

Some donors may choose to direct all or a portion of the funds paid from the lead trust to a donor advised fund sponsored by a community foundation or other entity and provide that their children advise on the disposition of all or a portion of the income from their inheritance while they wait to receive it. The children can thus learn about the philanthropic responsibilities their parents believe comes with their wealth before they enjoy the benefits of its complete ownership.

### **Creating a "Flexible Endowment"**

In today's environment there are many philanthropically inclined persons who have amassed substantial wealth but are still in the "accumulation" phase of life, and do not yet feel comfortable in parting with large amounts of their

capital, because they are not yet “finished” with it. This will be increasingly true as a larger percentage of wealthy persons who are philanthropically inclined come from the ranks of the baby boomers who are now in the age range of 37 to 55.

Entrepreneurs and those with significant equity holdings in entrepreneurial ventures have accounted for much of the wealth that has been created during the past 20 years. Traditionally, such persons do not engage in philanthropy until later in life after they have retired and “cashed out” their capital. That is often not from a lack of interest, but rather the perceived lack of ability to make significant gifts from illiquid assets. The capital they have is a precious commodity that was obtained through bootstrapping earnings, borrowing, or the sale of equity interests in their enterprise.

These persons may also have much higher levels of risk tolerance than those who manage charitable endowment funds.

They sometimes believe they can earn much greater returns on their capital than endowment managers, and many times they are correct.

During recent years, leading institutions including Cornell University and others, have pioneered a concept known as Flexible Endowments, Virtual Endowments, or other similar appellations.

Whatever they may be called, such gifts typically involve one or more of the following features:

- A donor makes a gift commitment of a substantial sum.
- Annual payments are made equal to the charity’s opportunity cost.
- The eventual endowment amount is indexed at rate of growth of charity’s endowment assets.
- The commitment is fulfilled at time of sale of business, death, or some other agreed upon time.

The term, “flexible endowment” was coined to describe the flex-

ibility experienced from the perspective of the donor. The term “virtual endowment,” on the other hand, is sometimes used to describe this gift vehicle from the perspective of the charitable recipient, as it is the immediate beneficiary of a flow of income very similar to what would have been enjoyed had the donor transferred full ownership to the capital.

**Example:** John, age 48, is the founder of a very successful business. He started the business on a shoestring 15 years ago. Today it enjoys a market capitalization of \$100 million. John has sold much of the equity in the company over the years to raise working capital. He now owns \$25 million worth of the stock and does not wish to further dilute his ownership in the company. He believes that his shares will grow in value rapidly over time and be worth more than \$500 million in ten years when he plans to sell his remaining stake in the business and retire. His income is now in the range of \$2 million per year.

John was rated as capable of

making a \$5 million gift to a campaign for endowment. After being asked for this gift, he responded that he was flattered to be considered to be capable of making a gift of this size, but he did not have liquid assets sufficient to fund the gift, and he was not in a position at this point to take more capital out of his company to make it possible to make this gift, as he does not want to decrease his percentage of ownership or seem to be evidencing to fellow investors a lack of confidence in the future of his firm. He also believes that if he keeps his capital employed in his company, his stock value will grow at a projected rate of 14 percent annually, twice the 7 percent total return anticipated by the managers of the charity's endowment funds.

After subsequent discussions, John agreed to fund a flexible endowment in the amount of \$5 million. The terms of his gift are as follows:

- He makes an irrevocable, legally enforceable pledge in the amount of \$5 million.
- Each year, John pays an amount equal to an agreed upon percentage of the flexible endowment amount or the actual percentage of endowment spending for that year, as agreed upon at the time the gift commitment is completed.
- The virtual endowment amount is indexed upward or downward depending on the growth or decline in the charity's endowment assets (the adjustment could alternatively be tied to CPI or some other index).
- John agrees to complete payment of the indexed flexible endowment amount at the end of a specified period of time, at a time of his choosing, or at his death. The pledge is backed by a contingent bequest or other testamentary gift.

**From a gift crediting standpoint, a flexible, or virtual, endowment will often be announced as a gift for the full value of the commitment, as the charitable recipient has all the practical benefits it would have if the funds were resident in its endowment fund.**

Both John and the charity consider this gift commitment to be a "win-win" situation.

Looking ahead ten years, if the charity experiences a total return on its endowment of 7 percent, spends 4 percent on programs, and leaves 3 percent in its endowment funds, John's "completion amount" at that time would have been indexed to \$6.5 million. If John's stock grows at an annual rate of 14 percent, in ten years John will be able to complete his commitment while netting over \$70 million on a sale of his stock after payment of the pledge balance and all of the annual payments over the years. Because of the growth rate differential, it will require just 8.4 percent of his assets to satisfy the pledge in ten years rather than the 20 percent of his assets it would require today. If the arrangement continued and John's estate fulfilled

the pledge at his death in an estimated 25 years, it would require less than 2 percent of the anticipated value of the stock to complete a pledge that would be indexed to \$10.1 million at that time. Note that for whatever period the commitment remains outstanding the charity is receiving payments from John each year equal to the 4 percent of the "endowment" it would be spending if the funds were in hand. If the flexible endowment is in existence for ten years, in addition to the final payment of the indexed endowment principal amount, John will have paid a total of \$2.3 million over time. Over 25 years, John would have made annual payments to the charity \$7.3 million.

In the example above, while one may legitimately question whether John will actually earn 14 percent on his capital over the years, the fact remains that many persons in John's position believe they can return significantly more on their capital than those who are managing assets for traditional endowment returns. In other cases, especially in times of economic uncertainty, a donor may simply feel they must continue to maintain access to their capital. While they are not comfortable with transfer of underlying assets, they may have sufficient income to "monetize" their endowment pledge from the charity's perspective until such time as they have the means and/or the confidence to completely fulfill their gift.

There are a number of variations on the plan outlined above. As noted in the example, the annual payment can be tied to the actual rate endowment spending of the charity, or an initial amount could be agreed upon and then indexed using the consumer price index (CPI). Likewise, the "endowment" amount could be indexed by the amount of the change in CPI or other index rather than the growth experienced by the charity. This removes the effect of investment and spending rate fluctuations that may occur that are beyond the control of the donor.

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will often be announced as a gift for the full value of the commitment, as the charitable recipient has all the practical benefits it would have if the funds were resident in its endowment fund.

Elimination of the estate tax would have little impact on this gift as it functions as a substitute for a current gift. With no estate tax, donors would have a greater incentive to fulfill the pledge during lifetime when income and capital gains tax savings could be realized, as there would be no tax advantage to a bequest and capital gains taxes would, under current law, no longer be avoided at death due to the scheduled elimination of the "stepped up" basis at death.

### Conclusion

The world we live in is constantly changing. Economic cycles come and go. There is perhaps no historical precedent for the amount of wealth that has been created over the past several decades. Some may continue to build their wealth. Others may lose a

portion of what they have accumulated. In any event, short of a complete economic meltdown, history tells us that philanthropic activity will continue and will in all likelihood grow. At the same time, demographic realities tell us that business and governments both in the U.S. and abroad will be hard pressed to provide for the needs of aging baby boomers at the same levels as previous generations. As a result, nonprofits and NGOs will in all likelihood be called upon to do more than in the past.

During more challenging economic times the form of charitable gifts can be expected to change. But regardless of economic cycles, there will apparently always be those among us who have been given to a philanthropic spirit. Those persons tend to be among our brighter lights, those who for whatever reason decide use a portion of the energy they have stored in the form of their accumulated capital to point the way to a better future for us all. One of the most rewarding aspects of the role of

estate and financial planners and representatives of charitable interests is the privilege of helping these special people accomplish their goals in ways they may never have thought possible. ♦

*Editor's Note: This article is excerpted in part from a presentation Mr. Sharpe made on the impact of current economic and tax law changes at the The American Bankers Association Trust, Asset Management & Marketing Conference in New York on January 28, 2002.*

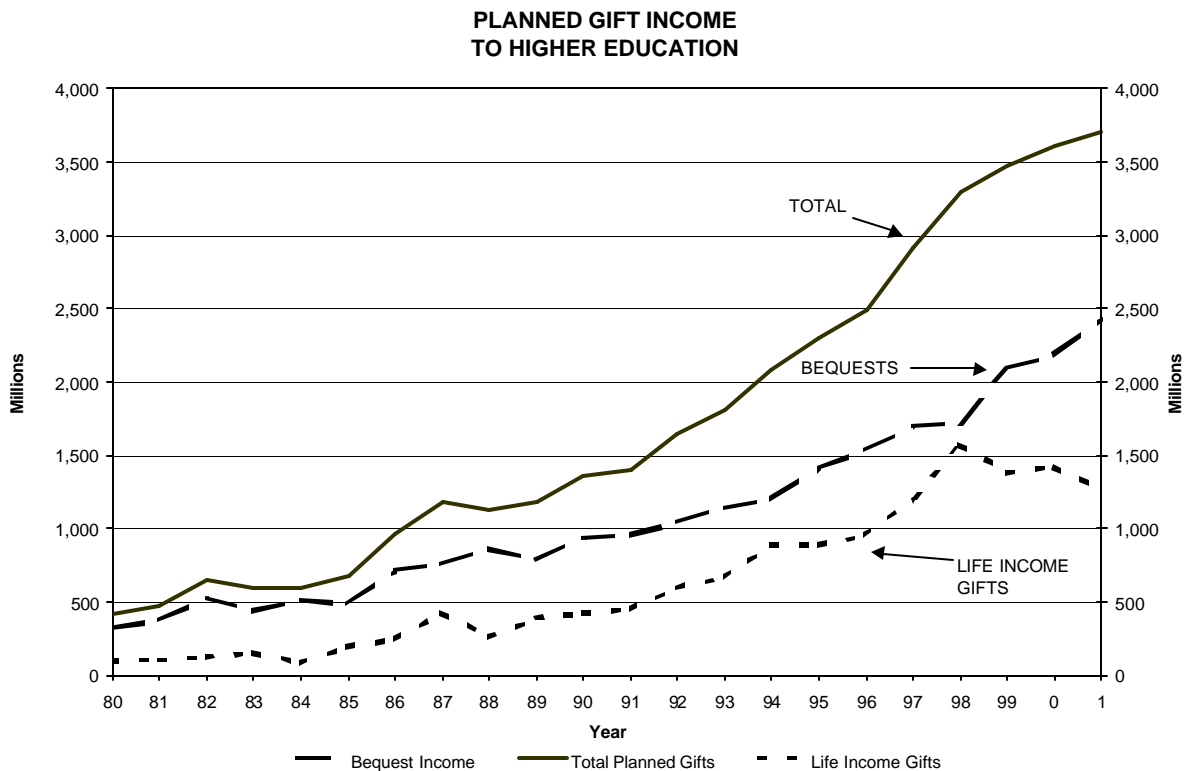
### ENDNOTES

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## Another Record Year for Bequests To Higher Education

The Rand Corporation's Council for Aid to Education (CAE) reported that charitable bequests to American colleges and universities set an all-time record for 2001. Bequests to higher education increased 12% over 2000 levels to \$2.4 billion. Bequest receipts amounted to almost twice the \$1.27 billion reported for the face value of charitable remainder trusts, gift annuities, and other deferred gifts. The \$3.7 billion in combined planned gifts amounted to 36% of all gifts from individuals to higher education for fiscal 2001, the same as the average percentage for the past twenty years.

	2000	%	2001	%	Growth
Outright Gifts	\$6,476,339	64%	\$6,478,968	64%	0%
Planned Gifts	\$3,602,155	36%	\$3,705,106	36%	3%
All Individual Gifts	\$10,078,494	100%	\$10,184,074	100%	1%
Bequest Receipts	\$2,182,738	61%	\$2,437,217	66%	<b>12%</b>
Deferred Gifts Funded	\$1,419,417	39%	\$1,267,889	34%	-11%
Total Planned Gifts	\$3,602,155	100%	\$3,705,106	100%	3%



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