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Wealth Management

Two Approaches to Charitable Giving

The benefits and drawbacks of charitable remainder trusts and private foundations

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Even if altruism is an individual's primary motive in making a charitable contribution, he should be aware of the substantial tax benefits of charitable giving, the different approaches to making such gifts, and the pros and cons of each approach.

A charitable remainder trust is an effective way to transfer assets to a charity or charities while still retaining an additional "income" stream from these assets. In other words, a charitable remainder trust provides for a specified amount to be retained by the donor and his or her spouse for a period of time and for the remainder to pass to charity when both ultimately pass away.

A common type of charitable remainder trust is the charitable remainder annuity trust (CRAT). Under a CRAT, the specified payout amount to the noncharitable beneficiaries cannot be less than 5 percent of the initial value of the trust corpus on an annual basis. The noncharitable beneficiaries would be entitled to receive only the fixed payout amount, irrespective of the growth of the asset contributed to the trust. To the extent that interest and dividends exceed the fixed payout amount, the trust principal will increase, thereby increasing the benefit the charity will receive from the remainder interest.

If interest and dividends do not reach the level of the fixed payout amount, or if the contributed assets depreciate in value, then the fixed annuity continues to be paid to the individual beneficiaries (from the principal), and the charity will receive less of a benefit from the remainder interest. The annuity payments must be made at least annually, and must continue for the life of the beneficiary (or for the lives of the beneficiaries, if there are more than one) or for a term of years. At the termination of this period, the remainder interest must be held by the trust for charitable purposes or paid to or for the use of a charitable organization.

Another approach to charitable giving is to create a private foundation. A private foundation is a charitable entity created to hold assets for charitable purposes, generally for distribution to publicly supported charities. The foundation's operations are controlled by trustees (if the foundation is formed as a trust) or officers and directors (if the foundation is formed as a corporation), which can be the creators of the foundation.

A private foundation enables a donor to maintain control in distributing the foundation's assets and other day-to-day operations. This provides donors with the flexibility to decide which charities to donate to as well as to make immediate gifts to charities, whereas charitable beneficiaries of a charitable remainder trust receive the benefit of the gift only upon expiration of the trust term. The ability to control the contributed property, coupled with the tax benefit discussed below, makes a private foundation an attractive vehicle to make charitable gifts.

Both approaches have significant income, gift and estate tax consequences. The grantors of a charitable

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remainder trust are entitled to a charitable income and gift tax deduction for the fair market value of the remainder interest, i.e., the value of the charity's interest in the trust. The value of the remainder interest is determined by actuarial tables provided by the IRS. The value of the income interest that the grantors retain will not be a taxable gift by the grantors (to themselves). However, the noncharitable beneficiaries receiving income from the trust will be responsible for paying taxes on the amounts received from the trust. Obviously, the larger the amount of the income interest retained by the grantors, the smaller the tax deduction.

When an individual creates and contributes to a private foundation during his lifetime, he is entitled to a current income tax deduction for the full fair-market value of the contributed asset (subject to limitations discussed below), as opposed to only the value of the remainder interest (as is the case for a charitable remainder trust). In addition, transfers to the foundation at an individual's death will qualify for the charitable estate tax deduction.

Contributions to both charitable remainder trusts and private foundations are subject to a number of restrictions relating to income tax deductibility, though the limitations on deductibility for contributions to private foundations are somewhat less generous than those applicable to charitable remainder trusts. If cash is transferred to a charitable remainder trust, the current income tax deduction for the charitable contribution will be limited to 50 percent of an individual's adjusted gross income (AGI), and if an appreciated asset such as stock is transferred to the trust, the deduction will be limited to 30 percent of one's AGI.

In contrast, cash contributions made to a private foundation are generally deductible up to 30 percent of one's AGI, while contributions of appreciated property are generally deductible up to 20 percent of one's AGI. In both cases, if the limitations are exceeded, the excess charitable contributions deduction may be carried forward for five additional years.

An advantage of creating a charitable remainder trust is to avoid having income tax imposed on an individual if he were to sell an appreciated asset. For example, by contributing appreciated stock to a charitable remainder trust, an individual would be shielded from recognizing capital gains on that transfer. In addition, he will generally not be subject to capital gains tax on a subsequent sale of the stock by the trust.

Another advantage of creating a charitable remainder trust is to have the benefits of an income stream flowing from the assets during one's lifetime while avoiding the income tax consequences arising from selling the investments oneself. For example, if an individual sold the stock and reinvested the proceeds to yield a higher return, a significant capital gains tax would be incurred. The tax would reduce the funds available for reinvestment, and consequently the resulting income stream would be reduced. This can be avoided if the stock is first transferred to a charitable remainder trust which then sells the stock. The stock sold will not be subject to capital gains tax, and all of the proceeds will be available for reinvestment to support a larger income stream.

If an individual is concerned that capital passing to charity (via the remainder interest) is reducing the amount of assets that normally would pass to the next generation, he can replace these lost assets if a portion of the increased annual income is used to fund an irrevocable life insurance trust. An individual can make annual gifts to the trust in an amount sufficient to permit the trustees to purchase a life insurance policy approximately equal to the assets that will pass to charity. These gifts can theoretically be paid from the tax savings resulting from the income tax deduction. If the transaction is structured in this way, an individual can increase his income during life and can make a significant contribution to charity without reducing the amount ultimately passing to the next generation. This technique is not available under the private foundation approach.

The primary advantage of using a private foundation is it allows a donor to maintain control over the investment and use of the contributed assets, as discussed above. It also can allow a donor's family to become involved as well. With the benefit of control, however, comes the burden of adhering to certain formalities. The foundation will have a separate legal existence, and therefore should maintain separate bank and investment accounts, such as checking or brokerage accounts. Where there is more than one trustee (or officer/director) serving, the trustees (or officers and directors) should hold at least one meeting each year, and they should approve any substantial charitable grant by the foundation at a meeting or by unanimous written consent of the trustees (or officers and directors). The Internal Revenue Service also recognizes the separate existence of the foundation, and requires it to file an application for recognition of its exemption from federal income taxes within 15 months of its organization. The foundation must also register with the Attorney General's Office in the State of New Jersey.

In addition, the foundation will be subject to certain rules applicable to private foundations generally. These rules are enforced through the collection (or potential imposition) of excise taxes. In general, tax on net investment income (generally 2 percent), which cannot be avoided, applies to all private foundations that earn net investment income. Other excise taxes, such as minimum distribution requirements, rules against self-dealing, and taxable expenditure rules, among others, are in the nature of penalties designed either to encourage or to prohibit certain types of activities or transactions by the foundation or its trustees (or officers and directors). For example, the taxable expenditure rules are designed to prohibit a foundation from engaging in participation in political and legislative matters, certain grants to individuals without prior IRS approval of the grant procedure, grants to organi-

zations other than public charities unless the grantor exercises “expenditures responsibility,” and grants for non-charitable purposes. The rules governing taxable expenditures are technical and complex, and as a result, many private foundations prefer to restrict their grants to public charities to avoid these rules. Similarly, because of the time and expense involved in setting up and maintaining a private foundation, some individuals opt for a different approach to charitable giving altogether.

Charitable giving provides significant tax advantages and remains an important part of modern estate planning. When deciding whether to use a charitable remainder trust or a private foundation as a vehicle for making charitable donations, one should consider several factors, such as whether the asset has substantially appreciated, limitations on deductibility and the level of control the donor wishes to maintain over the contributed asset. Discussing these issues with a tax advisor can assist an individual in reaching his or her estate planning and philanthropic goals. ■