It's Better to Give

BY ROBIN D. FERRIBY

Based on a 2001 survey conducted by the Michigan Nonprofit Association, 90 percent of Michigan adults give to charity annually. As Michigan citizens are committed to supporting charitable causes, attorneys involved in tax and estate planning should be aware of the tax rules for charitable gifts. Business and real estate lawyers should also be familiar with these rules as charitable gifts can help to avoid or delay capital gains on the sale of a business or real estate holding.

Lifetime Charitable Gifts

The amount of the income tax deduction that a client may claim on the client's federal income tax return is based on the type of property contributed, the type of charity to which the property is contributed, whether the property is "to" or "for the use of" the charity, and the client's "contribution base." The "contribution base" limit is commonly referred to as the "adjusted gross income" (AGI) limit. The reason for this is that the contribution base is equal to adjusted gross income computed without regard for any net operating loss carryback. As most taxpayers do not have net operating loss carryback, most commentators refer to an "AGI limit."

For the balance of this article, I will also refer to AGI limits for the sake of simplicity.

The most common type of gift is a direct gift of cash to a public charity. Public charities include publicly supported organizations, government units such as universities and public libraries, donor advised funds, and supporting organizations. A client may deduct up to 50 percent of their AGI for cash gifts to public charities. If the gift is not made "to" the public charity, but rather "for the use of" such as in an ongoing trust that supports the public charity, the deduction is limited to 30 percent of AGI.

However, if a taxpayer were to make the same cash gift to a private foundation, the deduction would be limited to 30 percent of AGI. Generally, private foundations are charities that are controlled and/or supported by a small group of individuals, typically a family or a business.

A client is permitted to roll over any excess deduction above the applicable AGI limit. The client may roll over the excess deduction for up to five additional years. Any unused deduction is lost if the taxpayer dies within the five-year period.

A primer on charitable tax deductions and planned gifts

Deductions for gifts of long-term appreciated publicly traded securities made to a public charity are limited to 30 percent of AGI. If these securities are donated to a private foundation, the tax deduction is limited to 20 percent of AGI. Gifts of appreciated long-term securities are valued at the fair market value on the date the securities are received by the charity. Any unrealized capital gains on the contributed property are not realized by the client. This results in an additional tax savings to the client as illustrated below.

A client that contributes ordinary income property, including short-term appreciated assets, will have their deduction limited to cost basis. As such, gifts of these assets are not generally made. Likewise, gifts of long-term, depreciated assets are deductible at fair market value, but the client will not be able to claim the unrealized loss. In this situation, it is generally better for the client to sell the property and recognize a deductible capital loss. The client can then contribute the proceeds and claim an income tax deduction for the full value of the cash gift.

Gifts of real estate and closely-held business interest are more complex. While the general rules on deduction limits above still apply, the client will need to obtain a qualified appraisal if the contribution is worth more than $5,000, and file U.S. Form 8283. The charity must also report to the IRS the sale price obtained by it, if the property is sold within two years of receipt. This permits the IRS to compare the deduction claimed by the client to the amount realized by the charity to see if an inappropriate deduction was claimed.

The value of a contribution of real estate or closely-held business interest to a private foundation is limited to the taxpayer's cost basis in the property. With highly appreciated assets, this significantly reduces the tax benefit for making gifts of these interests to a private foundation. However, the client may claim a full fair market value deduction if such property is contributed to a public charity. This valuation difference alone greatly favors making these types of contributions to public charities.

Tangible personal property can also be troublesome. The value for the property has to be established by appraisal or other appropriate method. If the personal property being contributed is not related to the purposes of the recipient charity, the donor's tax deduction is limited to the lesser of cost basis or fair market value. For example, the contribution of a collectible painting to a human service agency for sale during its charitable auction would not be deductible at fair market value. However, the client could claim a fair market value deduction if the same painting were contributed to an art museum to be added to its collection for display.

Attorneys must also be mindful that Section 68(a) of the Internal Revenue Code can reduce charitable deductions in the case of individuals whose adjusted gross income exceeds the "applicable amount" ($142,700 for a married couple filing jointly in 2004) by the lesser of three percent of the excess of adjusted gross income over the applicable amount, or 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year. Note that since Michigan income taxes are more than the three percent phaseout rate, the phaseout first affects the income tax deduction leaving the charitable deduction free from any reduction in many cases.

Lastly, an increasing number of taxpayers are being subjected to the alternative minimum tax. It is possible that the imposition of this tax on a client can reduce the after-tax benefit of a charitable deduction.

Planned Gifts

Clients can also realize tax savings through several forms of planned giving arrangements wherein the donor retains an income stream or other interest in the contributed property. These planned gift arrangements include charitable remainder trusts, pooled income funds, charitable gift annuities, qualified remainder interests in residences, charitable lead trusts, and conservation easements. Specific and technical rules must be followed when entering into such transactions.

In general, each of these gifts involves an irrevocable transfer of property for the benefit of a charity or charitable cause. The client or client's beneficiary retains some form of interest in the contributed property. The client is permitted to claim a charitable income, estate, and/or gift tax deduction for the portion of the property passing to charity.

Additional Tax Savings

	Cash	Stock
Donation	$10,000	$10,000
Basis	$10,000	$2,000
Unrealized Gain	$0	$8,000
Capital Gains Tax Avoided	$0	$1,200
Tax Deduction for Gift (35 percent)	$3,500	$3,500
Total Tax Savings	$3,500	$4,700

Examination of a typical charitable gift annuity transaction can illustrate the benefits of a planned gift arrangement. A charitable gift annuity is a form of bargain sale in which the charity issuing the annuity promises to pay an income beneficiary (or two) a specific dollar amount annually for life. In exchange for this promise, the client irrevocably transfers property to the charity.

Assume a 65-year-old donor contributes $10,000 worth of appreciated stock with a cost basis of $2,000 to a charity in exchange for a gift annuity. The stock pays a two percent annual dividend. The charity will provide the client six percent ($600) a year for life. The client will be allowed to claim an immediate charitable income tax deduction $3,550, representing the value of the contribution reduced by the present value of the retained annuity payments. This present value is computed using a formula published in the Treasury Regulations.

The client will not have to recognize any capital gains upon the creation of the gift annuity. The tax characterization of the $600 payments to the client each year will be $260 as capital gains (based on the life expectancy of the donor and the cost basis in the contributed property), $275 as ordinary income and $65 of tax-free return of basis. Once the taxpayer reaches their presumed life expectancy, all future payments on the annuity are treated as 100 percent ordinary income.

In this quick example, the client was able to avoid immediate taxation on $8,000 worth of capital gains spreading a portion of that capital gain out over several years, increased the income from the contributed stock from a two percent dividend to a six percent annuity payment, realized a $3,330 immediate income tax deduction, and supported a favorite charity.

Similar benefits can be obtained through the other planned gifts mentioned above, though the computation of the deduction and the tax characterization of the income payments are subject to different rules than are applicable to gift annuities. An attorney wishing to properly advise a client contemplating a planned gift should be familiar with the benefits and characteristics of each vehicle so that the proper arrangement for a particular client can be selected.

Fast Facts:

The most common type of gift is a direct gift of cash to a public charity.

Clients can also realize tax savings through several forms of planned giving arrangements, wherein the donor retains an income stream or other interest in the contributed property.

Michigan tax law provides a credit for a gift to: (i) public institutions, such as universities and public broadcasting stations, (ii) homeless shelters and food banks, and (iii) endowment funds at community foundations.

It should also be noted that the deduction limits noted above apply to planned gifts. Therefore, if a planned gift is established to benefit a private foundation, the income tax deduction generated for that contribution is subject to the private foundation AGI limits and valuation rules. However, if the planned gift benefits a public charity, then the higher AGI limits and more favorable valuation rules will apply to the computation of the charitable deduction generated by the planned gift.

Michigan Tax Credits

Often overlooked on both the Michigan income tax return and the Michigan single business tax return are three credits applicable for charitable contributions. Michigan law provides a credit for a gift to: (i) public institutions, such as universities and public broadcasting stations, (ii) homeless shelters and food banks, and (iii) endowment funds at community foundations. These Michigan credits are in addition to the federal income tax deduction. These credits are 50 percent of the value of the gift subject to certain limitations. A client can annually claim a credit for a gift for each of the three categories but cannot claim multiple credits for multiple gifts in any one category.

The most infrequently used of these credits is the gift to community foundation endowment fund. This credit is limited to $200 (based on a $400 gift) for a married couple filing a joint return, $100 (based on a $200 gift) for a gift made by a single individual or married couple filing separately, the lesser of $5,000 or 10 percent of tax liability before claiming any credit (based on a $10,000 gift) for a Michigan trust or estate paying income tax, and the lesser of $5,000 or five percent of tax liability before claiming any credit (based on a $10,000 gift) for a Michigan taxpayer paying single business tax. The benefit of the tax credit can be illustrated below.

It is important to note that there is no attribution between related businesses with respect to the single business tax credit. Therefore, a group of related businesses

Benefit of the Tax Credit

Gift	$400
Michigan Credit	($200)
Federal tax deduction ($400 gift less reduced income tax deduction due to credit of $200 multiplied by 35 percent tax bracket)	($70)
Net cost of gift	$130

each filing separate single business tax returns can each claim their own single business tax credit.

Estate Planning

While 90 percent of Michigan adults give annually to charity, less than 30 percent of Michigan estate planning attorneys regularly discuss charitable giving with their clients when preparing estate plans. This is an interesting dichotomy since it would make sense that if most people give, lawyers should consider the tax savings opportunities available during the estate planning process.

Charitable gifts are not subject to gift, estate, and generation-skipping transfer taxes. Therefore, a taxpayer can make a gift to charity upon death and have that contribution excluded from estate taxes.

This rule also permits a client to establish a planned gift such as a charitable remainder trust for the benefit of his/her children at death and have part of the trust excluded from estate taxes based on the computed remainder that will pass to the charity. Such planning techniques can increase the amount available to the children by permitting the property that otherwise would have been used to pay estate taxes to remain invested for the benefit of the children.

It is also possible to establish charitable planned gifts during a lifetime and use the income tax savings or increased income generated by the planned gift to purchase insurance that ultimately passes to the family. These "wealth replacement plans" typically include an irrevocable life insurance trust that passes transfer tax free to the family in substitution for the property that has been given to charity. These types of arrangements can permit a client to provide for favorite charitable causes while at the same time taking care of the needs of family.

Charitable gifts can also be beneficial for taxpayers selling a business or real estate. A portion or all of a business or property to be sold can be contributed to charity or added to a planned gift arrangement. The client can then claim a charitable deduction for value of the property passing to charity and shelter some of the gains generated in the sale. If a planned gift is used, the client can retain an income stream from the contributed property for their lifetime. These arrangements can reduce the tax costs of the sale while providing for the client's retirement in a tax cost effective manner.

When contributing any property to a charity or into a planned giving arrangement, the client and attorney must be cautious of the "pre-arranged sale" rule. This rule imputes the gain realized when the charity sells the property back on the client even though the client has already contributed the property to a charity. This takes place when a client contributes property that is subject to a binding sales agreement to a charity and the charity is obligated to consummate the sale after it's contributed. If the charity is not bound to sell the contributed property, the realized gains on the contributed property are not taxable to the donor when the charity sells the contributed property.

It is therefore advisable that a taxpayer contribute real estate, closely-held business interests, or other property prior to entering into any binding agreement to sell the property. If at all possible, property should be contributed and the charity should list and otherwise market the property for sale.

Charitable deductions are one of the few remaining tax planning techniques available that can actually benefit your client, his/her family, and the charitable causes that the client cares about. It is important that all lawyers are aware that these opportunities exist so that they can be considered in business and financial planning situations. If 90 percent of our clients are making charitable gifts, it is important that each of us is aware of the availability of these deductions and the rules surrounding them. ✦

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