Visual Planned Giving

(in color)

An Introduction to the Law & Taxation of Charitable Gift Planning

Russell James, J.D., Ph.D.

Professor

CH Foundation Chair in Personal Financial Planning

Texas Tech University

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Russell James III, J.D., Ph.D.

Professor & CH Foundation Chair in Personal Financial Planning

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PREFACE

This is not your father's law and tax book (Part I). The purpose of this text is to communicate to fundraisers and financial advisors the basic concepts of planned giving in a friendly, straightforward, and visually attractive format, while providing explanatory text that might be helpful where the visual elements are insufficient. The intended use is for the reader to flip through the images in the sections of interest until reaching an image that seems new or confusing, at which point the surrounding explanatory text may be helpful. The citations in the text are relatively sparse and for those desiring more technical texts with superior citations I recommend Thomas J. Ray, Jr.'s, *Charitable Gift Planning*, Catherine W. Wilkinson & Jean M. Baxley's, *Charitable Giving Answer Book*, Bruce R. Hopkins' *The Law of Fundraising*, and Bryan Clontz's *Charitable Gifts of Noncash Assets (2nd Edition)*.

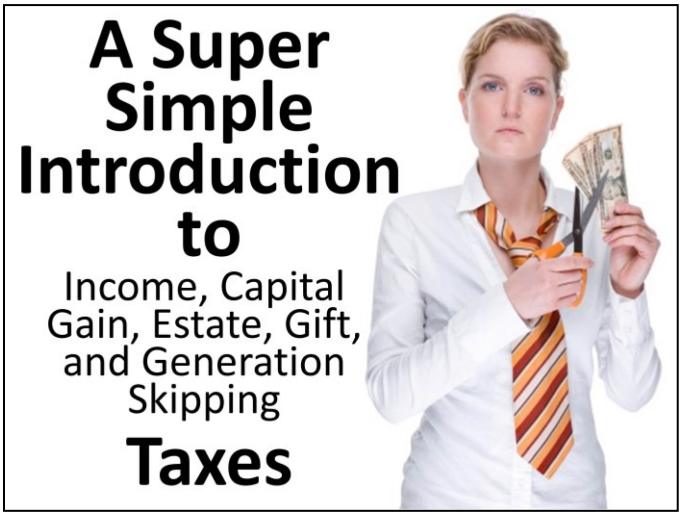
This is not your father's law and tax book (Part II). This book is intentionally published in a print-on-demand format. This means that changes can be incorporated into the current version of the book within a matter of days. It also means that I would be most appreciative of any information related to errors, trivial or otherwise, because these are easily corrected. Please e-mail me at russell.james@ttu.edu if you happen to find such. (Special thanks to Jill Gary Hughes, Leo O'Connor, Jr., Peter Hayward, Robert Constantine, and Ray Tyler for their past guidance in this way.) Note, however, that some errors of omission are intentional as this is not intended to be an exhaustive treatment of every possible transaction type and option, but rather is intended to be a basic primer on charitable gift planning.

The slides used in this text are from the courses that I have taught for many years as part of the on-campus and online Graduate Certificate in Charitable Financial Planning and Master of Science in Personal Financial Planning both in the Department of Personal Financial Planning at Texas Tech University, as well as in my course in Charitable Gift Planning at the Texas Tech University School of Law. Information on the online Graduate Certificate in Charitable Financial Planning is available at www.EncourageGenerosity.com. Additionally, the PowerPoint or pdf version of many of the slides contained herein and audio of some related lectures are also available, for free, at the website.

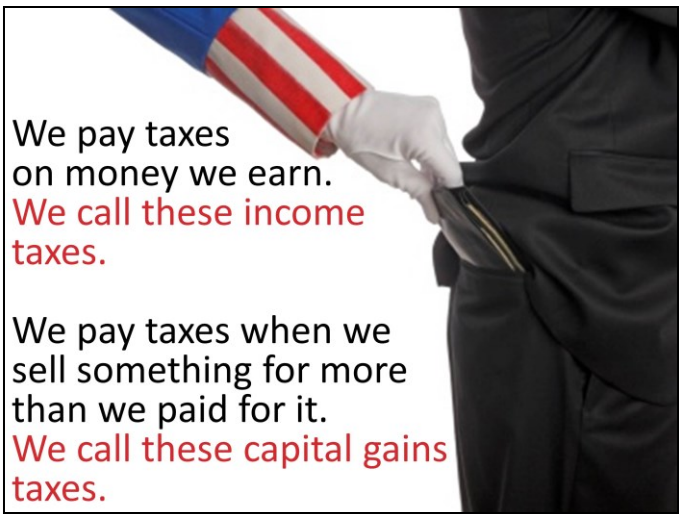
And now, on to the disclaimers: *This notice is made in order to comply with applicable Treasury Department and other regulations (including but not limited to Circular 230): This book is not intended to provide personal legal, tax or financial advice. Consequently, I urge you to seek the advice of your own legal, tax, or financial professionals in connection with gift and planning matters. This text is not intended to be used and cannot be used for the purpose of avoiding tax-related penalties.*

This document is for information and illustrative purposes only and does not purport to show actual transaction results applicable to your specific situation. It is not, and should not be regarded as, investment, legal, or tax advice or as a recommendation regarding any particular transaction or course of action. Opinions expressed herein are current opinions as of the date appearing in this material only and are subject to change without notice. Reasonable people may disagree about the opinions

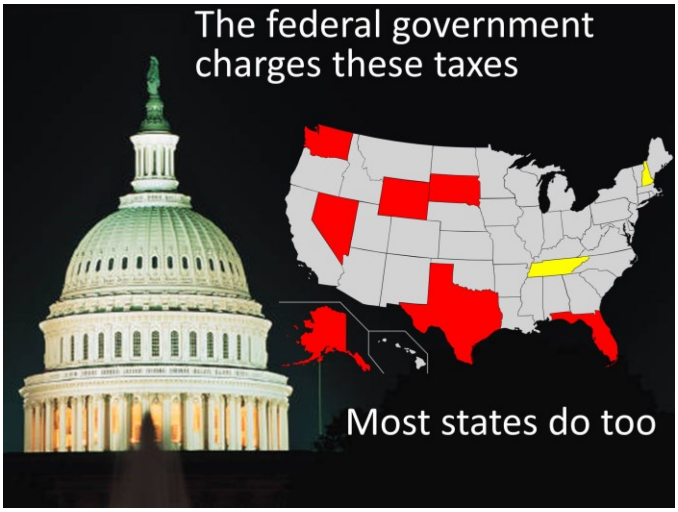
2 A SUPER SIMPLE INTRODUCTION TO TAXES



At its core, gift planning can accomplish two things. It can trade a gift for income, and it can reduce taxes. Most of the complexity in charitable planning comes from the desire to reduce taxes. Consequently, most of this text is focused on tax laws related to charitable giving. Before jumping into a review of the various charitable tax strategies, it may be useful to begin with a quick review of the fundamentals of the U.S. tax system.



Since 1913, the federal government has levied an income tax. For example, if a taxpayer earns a salary, he or she must pay a percentage of that earned income to the federal government in taxes. Taxes are also charged when a taxpayer sells an item at a profit (called a capital gain). Income from capital gain is taxed at different rates than earned income, and so is calculated separately.

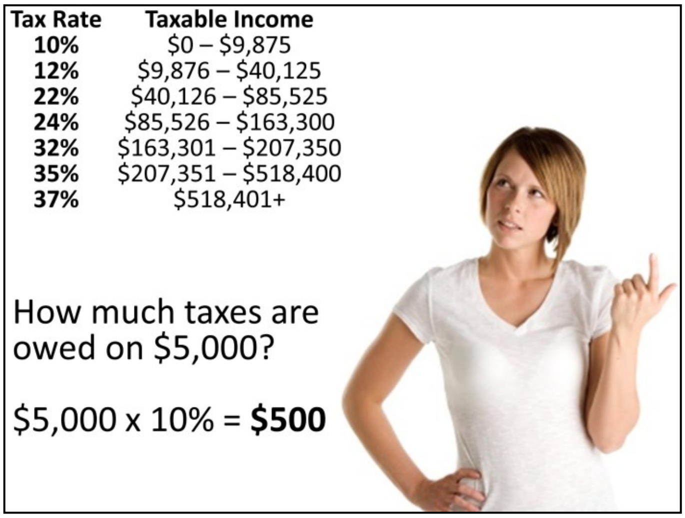


Not only does the federal government charge income and capital gains taxes, but most states do as well. Taxpayers in these states pay both federal and state taxes. In some of these states, the state rules for charitable deductions are identical to the federal rules. Other states reduce this deductibility or provide special incentives for particular types of charities. Given the variety of these rules, this book will not review the various rules for charitable deductions from state income taxes but will instead concentrate on the federal tax system.

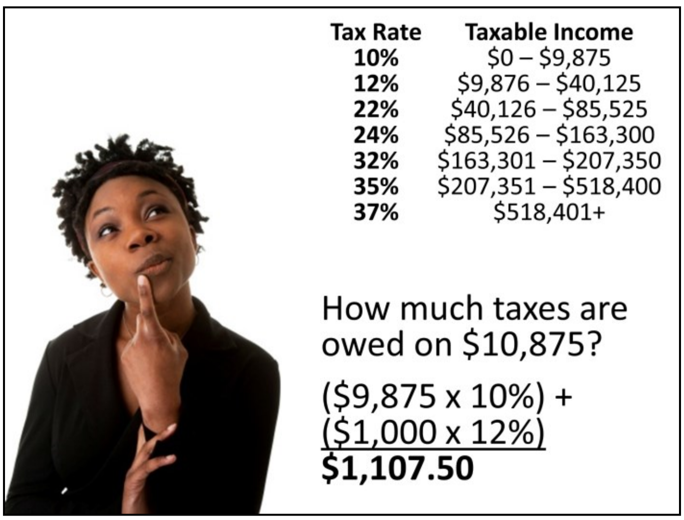
Income and capital gains taxes are not the only form of federal taxation, of course. The federal government charges taxes on the gratuitous transfer of money from one person to another, either at death (estate taxes) or during life (gift taxes).

A consistent feature of the federal tax system is that the tax rates are not flat. As income increases, the income tax rate increases and the capital gains tax rate increases. As estate size increases, the estate tax rate increases. As total gifts to other people increases, the gift tax rate increases. These increasing tax rates mean that the tax effects from the same transaction may vary dramatically from person to person. This text will most commonly calculate the effects for a taxpayer at the highest federal tax brackets and ignore state taxes, but the actual results will differ depending upon the actual tax circumstances of the individual donor.

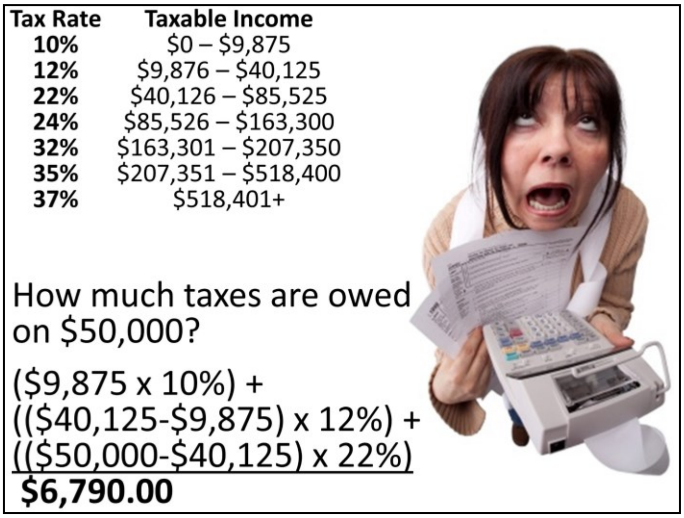
Just to illustrate this idea, the 2020 federal income tax brackets for a single person can serve as an example of increasing (a.k.a. "progressive") tax rates. As a taxpayer earns more money, he or she will tend to pay a larger and larger share of this earned income in federal income taxes. A "marginal" tax rate refers to the rate charged on the next dollar of earned income. Calculating taxes owed is not as simple as finding the marginal tax rate and multiplying it by the taxpayer's taxable income. Instead, each separate level of income is taxed at the rate indicated in the tax table.



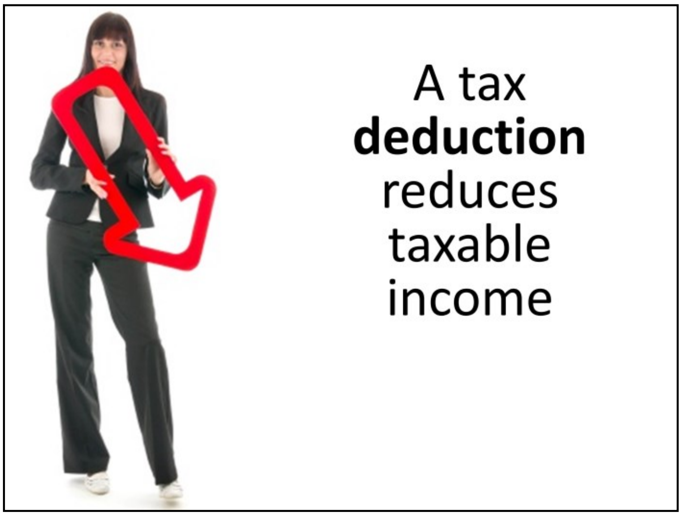
At the lowest level of taxable income, calculations only require using one rate. For example, a single taxpayer with $5,000 of taxable income in 2020 would pay taxes at the 10% rate for all of his or her taxable income. This taxpayer would owe $500 in taxes ($5,000 x 10%). However, beyond this lowest bracket of taxable income, calculating taxes owed becomes a bit more complicated.



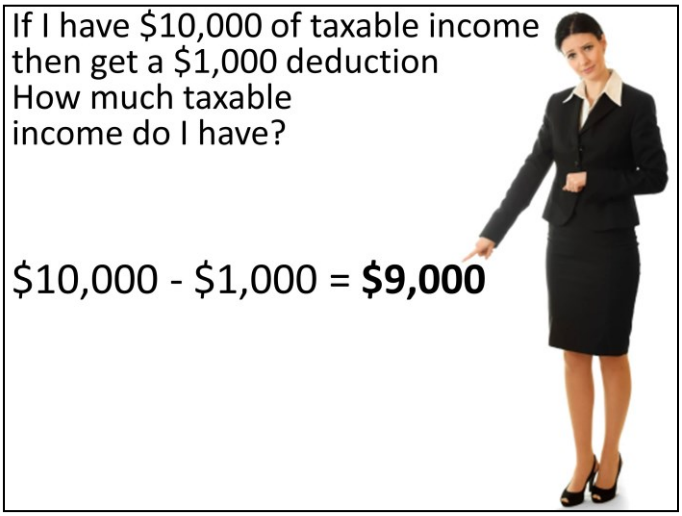
For example, if a single taxpayer had $10,875 of taxable income in 2020, then the first $9,875 would be taxed at 10%, and the remaining $1,000 would be taxed at 12%. It is incorrect to simply use the 12% rate for all of the taxpayer's taxable income. (I.e., do not simply multiply the total $10,875 of taxable income by 12%.) The 12% rate is the *marginal* tax rate, because it is the rate charged for the *next* dollar that the taxpayer earns. But the 12% rate does not apply to *every* dollar the taxpayer earns.



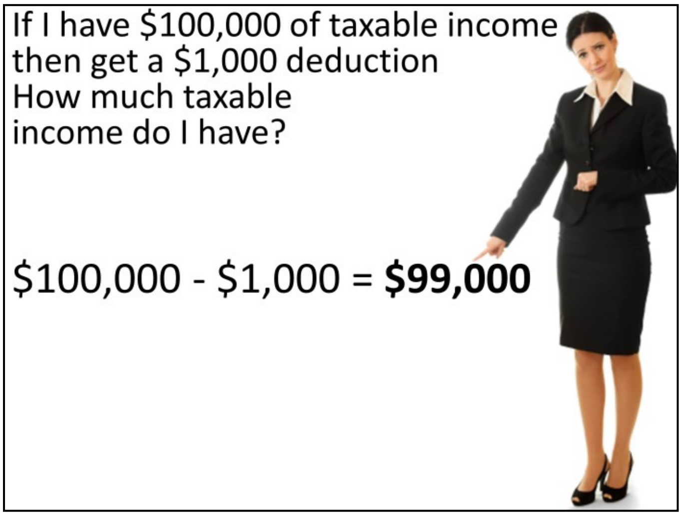
As a taxpayer earns more income and moves further up the tax brackets, calculating the income taxes owed requires more steps. For example, a single taxpayer with $50,000 of taxable income would pay a 10% rate on the first $9,875 of income earned, a 12% rate on the next $30,250 earned ($30,250 is the difference between the top of the 12% tax bracket, $40,125, and the top of the 10% tax bracket, $9,875), and a 22% rate on the final $9,875 earned ($9,875 is the amount of the $50,000 taxable income above the top of the 12% tax bracket which ends at $40,125).



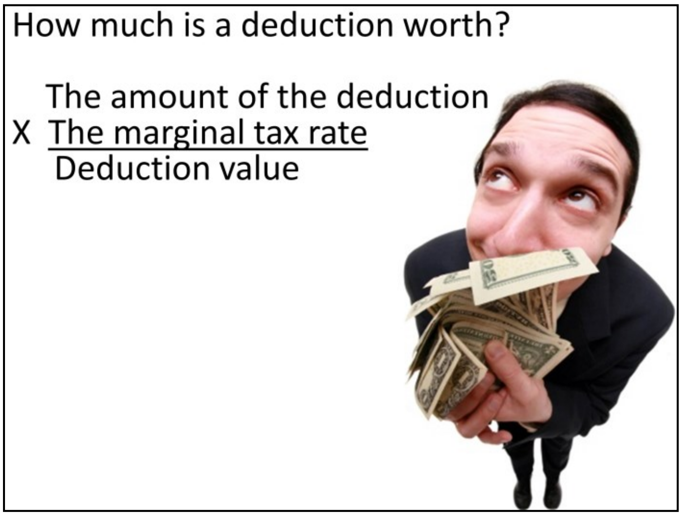
Charitable gifts may generate charitable income tax deductions. Consequently, it is important to know how to calculate the effects of such deductions. An income tax deduction reduces taxable income. The value of a reduction in taxable income is the tax owed at the original taxable income less the tax owed at the reduced taxable income. Thus, understanding the value of a tax deduction (such as a charitable tax deduction) requires the ability to calculate taxes owed at various levels of taxable income, and this requires understanding how tax brackets apply to taxable income.



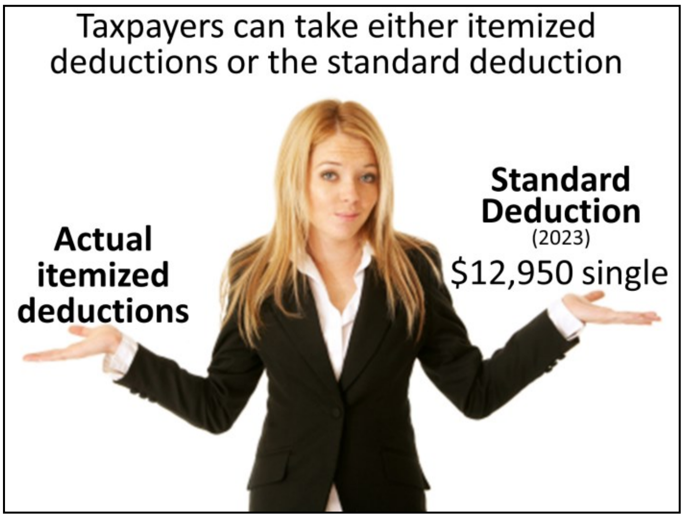
Tax deductions reduce taxable income. For example, a taxpayer with taxable income of $10,000 who then takes a $1,000 additional deduction will have $9,000 of taxable income.



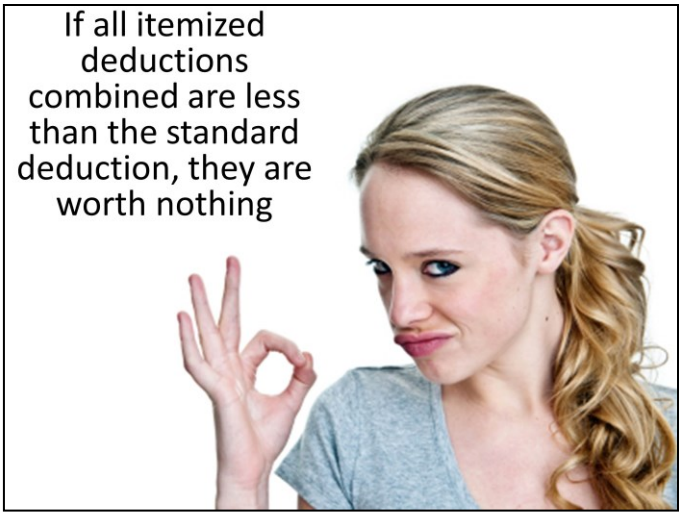
A tax deduction has the same effect on taxable income regardless of the amount of taxable income earned by the taxpayer. Whether the taxpayer's taxable income is $10,000, $100,000 or $10,000,000, an additional $1,000 deduction will reduce the taxpayer's taxable income by exactly $1,000. However, the *value* of the $1,000 deduction may vary greatly depending upon the taxpayer's taxable income.



A $1,000 deduction is not worth $1,000. The deduction amount indicates the amount by which taxable income will be reduced, but its value depends upon the tax rate of the taxpayer. Just because a $1,000 deduction reduces taxable income by $1,000 at all income levels does not mean it is worth the same at all income levels. Often the value of the tax deduction is the amount of the tax deduction multiplied by the taxpayer's highest tax bracket. So, a $1,000 deduction is worth $100 to a taxpayer in the 10% tax bracket. That same tax deduction is usually worth $370 to a taxpayer in the 37% bracket. This difference in value helps to explain why charitable tax deductions may be more interesting to those with higher incomes.

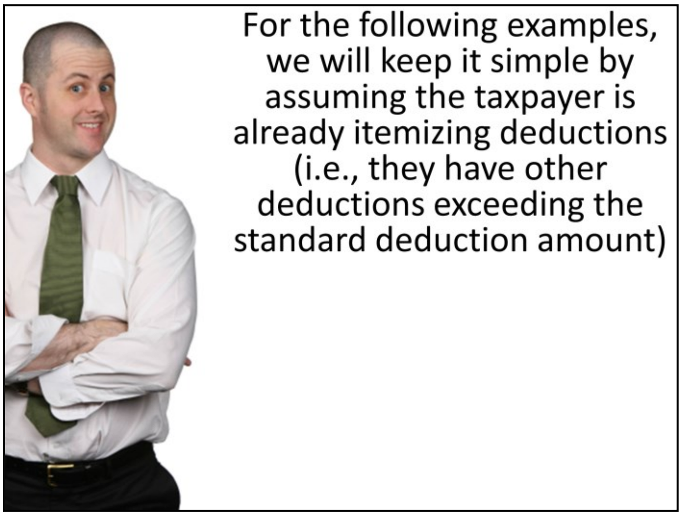


Charitable income tax deductions are an *itemized* income tax deduction. Other examples of itemized income tax deductions include the mortgage interest deduction, deductions for medical expenses greater than a set percentage of adjusted gross income, and deductions for state and local taxes up to $10,000. In order to use itemized deductions, a taxpayer must give up the standard deduction. So, a taxpayer who takes the standard deduction cannot use any charitable income tax deductions.

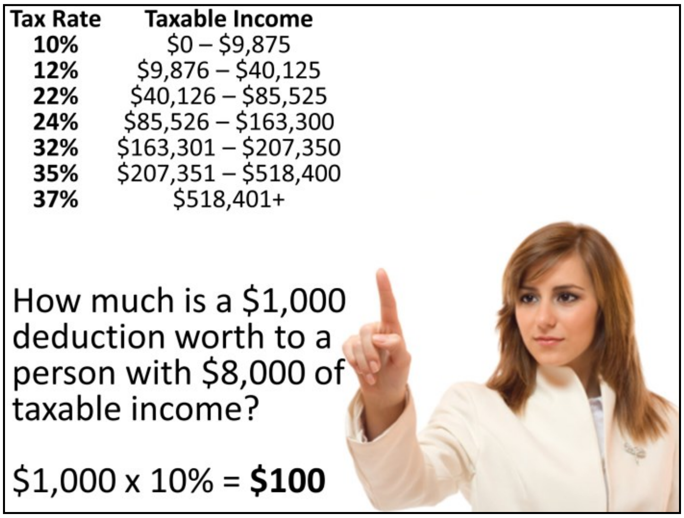


An itemized tax deduction such as a charitable tax deduction may, in fact, be worth nothing to a taxpayer. Consider the example of a single donor who made $4,000 of deductible charitable gifts in 2023 but had no other itemized deductions. This donor would face the choice of using either $4,000 of itemized deductions or using the $12,950 standard deduction. Obviously, the donor would be better off taking the standard deduction. Consequently, the $4,000 charitable income tax deduction has no value to this donor. This also helps to explain why charitable deductions tend to be of greater interest to higher income taxpayers. Such taxpayers are more likely to have other itemized deductions – principally the mortgage interest deduction – that are larger than the standard deduction. These "itemizers" can use the full value of any additional deductions because other deductions have already surpassed the value of the standard deduction.

Although the charitable income tax deduction is a common tax benefit of charitable transactions, it is not the only tax benefit. Thus, a good deal of charitable planning allows for positive tax consequences even for those taxpayers who cannot use the charitable income tax deduction. These tax benefits come not through deductions to reported income but by avoiding or postponing recognition of income in the first place. Thus, it is important to recognize that there is much charitable tax planning available even for donors who use the standard deduction.

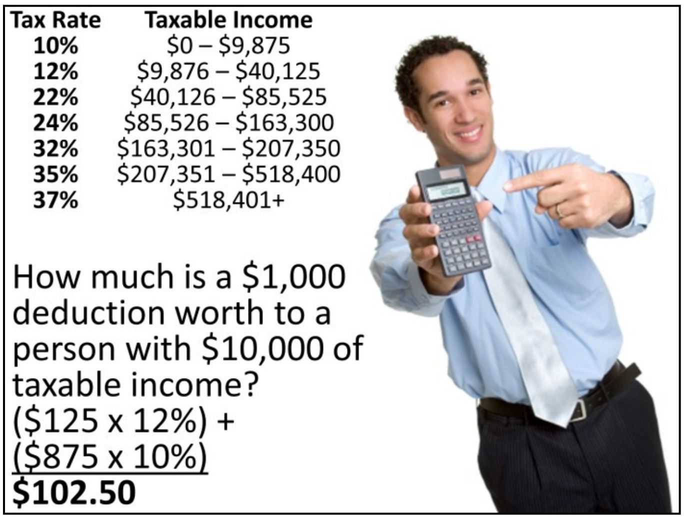


For the remainder of this text, the examples will assume that donors are already itemizers. In other words, due to other itemized deductions, the donors are assumed to be already foregoing the standard deduction. Consequently, the donors are assumed to use every dollar of any charitable deduction.



As mentioned previously, the value of a tax deduction depends upon the tax rate of the taxpayer. For example, a single taxpayer with $8,000 of taxable income in 2020 would pay $800 in taxes. If the taxpayer were to have received an additional $1,000 deduction, his or her taxable income would have fallen to $7,000 and he or she would have owed $700 in taxes. Thus, the $1,000 deduction would have caused the taxpayer's tax bill to drop by $100.

The same tax deduction is worth more to a higher income taxpayer. For example, a single taxpayer with $600,000 of taxable income in 2020 would pay $186,427.00 in taxes. If the taxpayer were to have received an additional $1,000 deduction, his or her taxable income would have fallen to $599,000 and he or she would have owed $186,057.00 in taxes. Thus, the $1,000 deduction would have caused the taxpayer's tax bill to drop by $370.

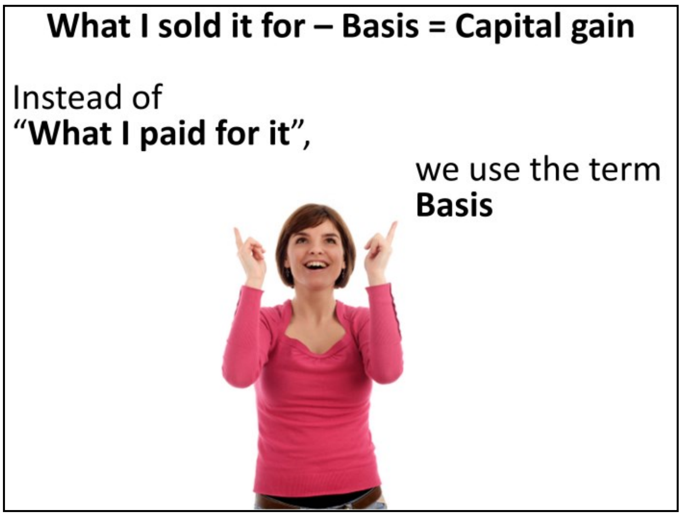


In the prior two cases, the quick way to calculate the value of the deduction would have been to simply multiply the deduction by the taxpayer's marginal tax rate (e.g., $1,000 x 10% marginal tax rate = $100 in the first example and $1,000 x 37% marginal tax rate = $370 in the second example). However, this simple approach does not work if the deduction causes the taxpayer's marginal tax rate to change. In that case, part of the deduction will be valued at the higher tax rate and part will be valued at the lower tax rate.

As an example, consider the value of a $1,000 deduction to a single taxpayer with $10,000 of taxable income in 2020. The taxpayer begins at the 12% marginal tax rate. However, after applying the first $125 of the deduction, the taxpayer now has $9,875 of taxable income and drops into the lower tax bracket. Thus, any further deductions will reduce taxation not at the original 12% rate, but at the lower 10% rate. The first $125 of the deduction reduces taxes at a 12% rate, and the final $875 of the deduction reduces taxes at a 10% rate. The value of the deduction is thus, ($125 x 12%) + ($875 x 10%) = $102.50.

Put another way, a single taxpayer with $10,000 of taxable income in 2020 would pay $1,002.50 in taxes. If the taxpayer were to have received an additional $1,000 deduction, his or her taxable income would have fallen to $9,000 and he or she would have owed $900 in taxes. Thus, the $1,000 deduction would have caused the taxpayer's tax bill to drop by $102.50.

A separate set of tax rates applies to capital gains. A capital gain occurs when a taxpayer sells an investment for more than he or she paid for it (including the cost of improvements). This profit – the difference between the sale price and purchase price – is the amount of capital gain.



Capital gain is calculated as the sales price less the taxpayer's "basis" (or "adjusted basis") in the property. In most circumstances, the basis is simply the amount that the taxpayer paid for the investment. However, the basis is not always identical with the original price.

What I sold it for – Basis = Capital gain

Basis is
+ what I paid for it
+ any money I spent improving it
 - any depreciation tax deductions I have already taken on it

Basis always starts as the amount paid for the investment, but it can be adjusted later. For example, if an investor purchases an apartment building for $1,000,000 and then spends $250,000 making capital improvements and additions to the building, the investor's basis would increase to $1,250,000 (the $100,000,000 original purchase price plus the $250,000 of improvements). This makes sense intuitively because in order to get the new, improved building the investor had to spend a total of $1,250,000.

Less intuitive is the effect of depreciation tax deductions. The investor who purchased the apartment building is allowed to assume for tax purposes that the building is slowly wearing out (i.e., depreciating). Each year, the taxpayer is allowed to claim this wearing out process (depreciation) as a loss, offsetting gains or income from certain other sources. These depreciation deductions reduce the taxpayer's basis in the property. (If this were not the case, the taxpayer would be able to deduct the same dollar twice, first as a depreciation deduction and later as a reduction of the capital gain.) Depreciation deductions do not apply to financial instruments such as stocks or bonds or to raw land. Consequently, this text will not address depreciation unless the transaction specifically involves a gift of developed real estate.

If I owned the item for more than one year, it is a **long-term** capital gain

2020 – Single filer

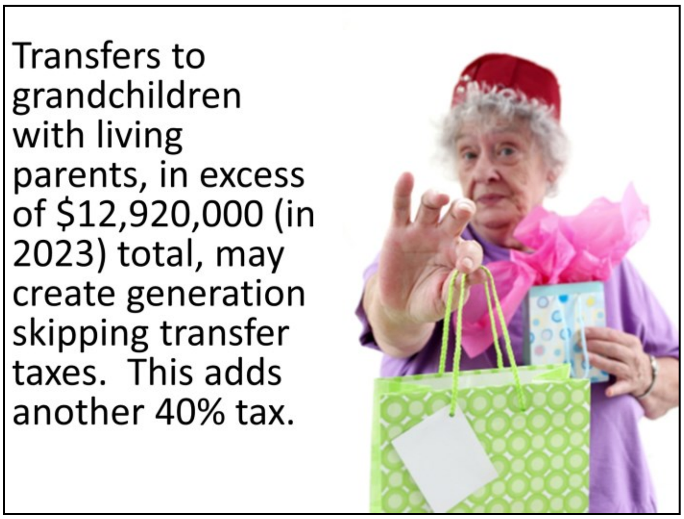
Taxable income	Long-term capital gains + Affordable Care Act (net investment income tax)
0-$40,000	0%
$40,001-$200,000	15%
$200,001-$441,450	18.8%
441,451+	23.8%

If the taxpayer owns the investment for more than one year, any gain is taxed as a long-term capital gain. Long-term capital gains tax rates are lower than those for ordinary income or short-term capital gains. The capital gains tax rates are 0%, 15%, and 20%. The Affordable Care Act imposes an additional 3.8% tax on net investment income of taxpayers over certain income thresholds (e.g., $200,000 of modified adjusted gross income for a single individual, $250,000 for a married couple filing jointly, not indexed for inflation). Net investment income includes capital gains as well as other types of investment income such as interest, dividends, rent, and royalty income. Consequently, depending upon the taxpayer's taxable income and modified adjusted gross income, capital gains are taxed at 0%, 15%, 18.8%, or 23.8%.

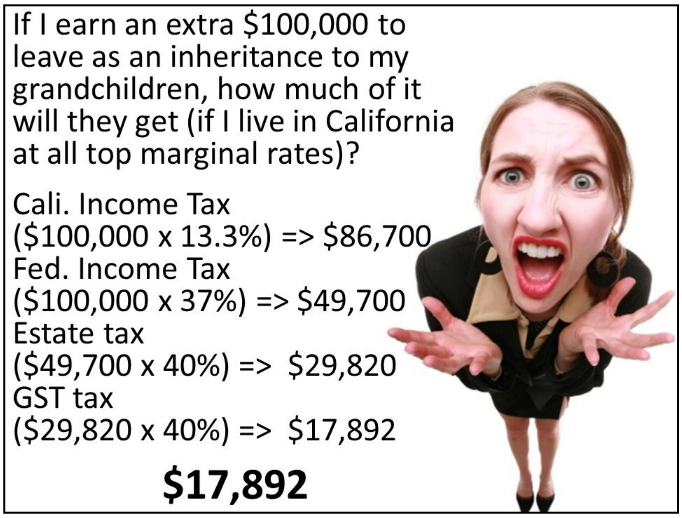
[*These rates do not depend only upon the amount of capital gain income, but rather depend upon the amount of overall taxable income and modified adjusted gross income. Consequently, all of the taxpayer's capital gains for a particular year will be taxed at the same rate unless the capital gain itself pushes the taxpayer into a higher overall income category for calculating the capital gain tax rates - otherwise there is no run up the rate schedule where some gains are taxed at 0%, then some at 15%, and so forth.*]

As described previously, the federal government charges taxes on gifts from one person to another, either at death (estate taxes) or during life (gift taxes). Transfers to charitable organizations are not taxable. Thus, any part of the estate that is transferred to a charity will not generate estate taxes. Similarly, any gifts made during life to charity will not generate gift taxes. This simple reality can be leveraged to create substantial estate tax planning opportunities using trusts such as a Charitable Remainder Trust or non-grantor Charitable Lead Trust.

Most people are not affected by estate and gift taxes because the exemption levels are quite high. For example, in 2023 there was no tax on estate and gift transfers that, when combined, do not exceed $12,920,000 for a single taxpayer or $25,840,000 for a married couple. Thus, estate tax and gift tax planning are now limited to the realm of the wealthy. However, estate planning can also affect other taxes, such as capital gains and income taxes, which are not limited to the wealthy. Thus, tax planning in estates can still be quite important even where estate taxes are not relevant.



An additional tax, referred to as the generation skipping transfer tax, can arise if the taxpayer makes transfers that "skip" a generation. For example, if a grandparent makes a gift (either during life or at death) to the child of his or her living child, this transfer skips a generation. The amount of these generation skipping transfers that, when combined, exceeds the exemption equivalent amount ($12,920,000 in 2023), will generate an additional 40% tax. This 40% generation skipping transfer tax is applied to the amount remaining after application of the 40% estate and gift tax. As with the estate tax, because of the high exemption amounts, these generation skipping transfer tax issues are a concern only for those taxpayers transferring substantial wealth. However, when they apply, the combined impact of these taxes can be dramatic.



As an extreme example of how burdensome the various types of taxation can become, consider the case of a taxpayer who wishes to earn an additional $100,000 to leave as an inheritance to his or her grandchildren. If this person were living in the state of California and at all of the top marginal tax rates (e.g., in 2023 having income over $1,000,000 and having previously made over $12,920,000 of generation-skipping gifts), the tax consequences would be severe. The additional $100,000 of income would first be subject to California's 13.3% state income tax, costing $13,300. In addition, it would be subject to the 37% federal income tax (with no additional federal deductions for the increased state taxes due to the cap on these deductions), generating a tax bill of $37,000. After paying the federal income tax, the remaining $49,700 could then be available to be inherited by the grandchildren. This transfer at death would generate a 40% estate tax costing $19,880 and leaving $29,820. However, if the grandchildren's parents were still alive, this estate transfer would skip a generation and thus be subject to the generation skipping transfer tax. This generation skipping transfer tax would generate an additional 40% tax on the remaining $29,820 costing $11,928 and leaving $17,892 for the grandchildren. Although certainly not commonplace, this extreme example shows just how important tax planning can be in the face of such potentially extreme tax consequences. As taxation increases, the value of tax planning – including charitable tax planning – also increases. Consequently, charitably inclined individuals facing significant tax burdens are often excellent candidates for sophisticated charitable planning.