GIVING THROUGH LIFE INCOME PLANS

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Sharing with others through our charitable giving can be one of life's greatest pleasures. Yet everyday financial obligations may sometimes limit what we feel we can give while maintaining our own security or that of our loved ones.

This need not be the case, however. The methods of giving described in these pages have been developed specifically to help you give while also helping ensure your continued economic security.

By carefully planning the form and timing of your gifts, you may find you can actually give *more* at a lower cost. These ways of giving can also help enhance your family's quality of life, both now and in years to come.

Read on for an overview of how multiple goals can be realized through thoughtfully developing your gifts, followed by a description of various options in more detail.

About gifts that "give back"

Some types of gifts allow you to receive an income for life or another period of time. In fact, you may actually be able to increase your spendable income as a result of making such a gift.

In order to accomplish this, you make a gift of cash or other property. The donated funds are set aside for a period of time during which they are managed by you or someone else you choose. You or others you name then receive income annually (or more frequently).

When the income interest ends, the charitable interests you specify receive the remaining funds.

Enjoy tax savings

A number of charitable gift planning vehicles can also be very flexible financial planning tools. They can be especially attractive if you are reviewing your financial affairs in light of changes in gift, estate and income tax laws.

The charitable deduction is one of the few items still within one's control for tax planning purposes. Many other deductions have been reduced or eliminated, but charitable gifts continue to receive favorable treatment under federal tax law.

The life income gift plans outlined in this booklet can result in welcome tax benefits, including:

- Sizeable income tax deductions that can yield immediate savings based on your tax rate. The higher the tax rate, the more you save. Deductions for these gifts can also make it possible to enjoy greater tax savings from other deductible expenses.
- Bypassing or delaying capital gains and other taxes on assets that have increased in value.
- Elimination or reduction of gift and estate taxes that may otherwise be due.
- Payments that may be received free of tax or at lower tax rates.

The following scenarios describe the many ways effective charitable gift planning can help enhance your financial security and fulfill your charitable wishes. Specific types of plans are discussed in more detail beginning on Page 8.

Scenario 1—Increase retirement income

The need for retirement planning is a focal point for many people today as life expectancies have increased, investment returns fluctuate and the number of individuals approaching retirement grows. Charitable gifts that provide income can actually help ensure prosperity in retirement years.

The challenge: Mr. Alexander, age 68, has been successful in investing his assets. Among his investments is stock worth $100,000 for which he paid $15,000 some years ago. The stock currently yields very little income. Mr. Alexander realizes he will need more income from his investments in the future. If he sells the stock and reinvests for higher yield, he will owe a large capital gains tax. If he continues to hold the stock, market fluctuations could result in losses with tax still due on any remaining gain.

A solution: In consultation with his advisors, Mr. Alexander decides to make a charitable gift in such a way that the stock can be sold and the proceeds reinvested without paying the capital gains tax that would otherwise have been due.

He will enjoy more income than he is currently receiving and it will continue for the remainder of his life. If he wishes, payments can also continue for his wife's life, should she survive him.

Mr. Alexander will also be entitled to a sizable income tax deduction in the year he makes his gift. The amount of the deduction depends on his age, the type of plan selected, the rate of payment he chooses and other factors. His deduction for this gift will be more than his standard deduction and will allow him to deduct certain taxes and interest that he does not normally itemize on his tax return.

The tax savings and all or part of his additional income could then be used to buy life insurance on his life for his grandchildren, which will help replace the value of the assets he donated—thereby ensuring that his grandchildren will receive the same or greater inheritance.

Scenario 2—Support loved ones

A well-planned charitable gift can also provide support for others you choose, either now or in the future.

When a surviving spouse or other income recipient has limited experience in financial matters, such gifts can also be arranged in ways that provide professional management of funds.

The challenge: Ms. Nelson, age 58, has a comfortable income and an adequate retirement program. She has managed to accumulate other assets as well. For several years, she has been helping support her father, who is 82. She is giving him $6,000 each year from her after-tax income. In her tax bracket she must earn nearly $9,000 to net this amount.

A solution: After considering various options with the help of her advisors, Ms. Nelson decides to fund a charitable gift plan that will pay $6,000 to her father per year for his lifetime, regardless of her ability to continue assisting him. And since the remaining funds will eventually become a charitable gift (to fund a memorial for her parents), Ms. Nelson is entitled to a large tax deduction in the year she arranges the plan.

She intends to reinvest the tax savings in her personal retirement program, comfortable with the knowledge that her father is provided for now and in the future.

Scenario 3—Fund educational expenses

There are also ways to give that provide income for a period of time, rather than for the lifetime of one or more people. If you have considered making a significant gift but have children or other loved ones who will need help paying for their education, consider such a gift plan as a way to meet their needs in a tax-efficient manner.

The challenge: Mr. and Mrs. Rowe have two teenaged grandchildren. The grandchildren plan to attend college, and the Rowes have promised to help with their expenses. They are looking for a way to help their grandchildren while making a significant charitable gift.

A solution: The Rowes learn they can accomplish both of their objectives. They create a plan that will pay an annual sum to each grandchild for a period sufficient to complete their education. The remaining funds will then be used to make a sizable charitable gift.

The Rowes will enjoy an immediate tax deduction for the future value of their charitable gift, while knowing that funds will be available for their grandchildren's education as well.

Recent tax legislation has increased amounts that can be given to loved ones tax free during one's lifetime. Plans such as the Rowes' can be an excellent way to take advantage of these increases.

How these results are achieved

As there are a variety of available plans, your needs will help determine your choice. If you have property (such as securities) that has increased in value, consider using it to fund your gift plan. Capital gains tax, which would be due if the property were sold, may be partially or fully bypassed or postponed, provided you have owned the property long enough for it to qualify as long-term property—currently more than one year.

Plans providing steady income for life

You can make charitable gifts in ways that provide a fixed income for life. Payments remain the same each year and can continue for your life or the life of a surviving friend or family member.

Two methods of giving that feature fixed income payments are the *charitable gift annuity* and the *charitable remainder annuity trust*.

The gift annuity: Under this plan, a sum of money or certain other property may be given to a charitable entity while one or two people receive fixed annual payments for life.

Gift annuities are especially attractive in times of relatively low interest rates, and many are pleased to learn that the payment rates are larger at older ages.

An income tax deduction is allowed in the year the gift is made. It is based on the age(s) of the person(s) receiving the income, the frequency of payments and other factors. Capital gains tax is generally avoided at the time your gift is made, and part of each payment is received free of income tax or at what may be lower capital gains tax rates for a period of years.

Gift annuities can be an especially affordable way to make a gift that provides income, as it is often possible to establish them in relatively smaller amounts. See the Nelson example on Page 6.

The fixed-payment trust: Much like a gift annuity, a *charitable remainder annuity trust* allows for separate management of your assets while providing fixed payments of at least 5% for the life of one or more people. It can also be established to last for a fixed period of time up to 20 years, if desired.

Such a plan is often used to generate income for retirement or fund educational expenses for a limited time. It can be used to help a child or grandchild get a start in life, with the funds becoming a charitable gift at the end of a period of time you specify. See the Rowe example on Page 7.

Tax deductions similar to those available for charitable gift annuities are also available when an annuity trust is created. When you have property that has increased in value, a charitable remainder annuity trust can make it possible to increase your income without incurring capital gains tax at the time the gift is completed.

Under certain circumstances, however, payments from the trust may be partially taxed at lower, more favorable capital gains tax rates as they are received. Tax-exempt income is also possible under some circumstances.

Plans with payments that vary

Some people prefer that their income fluctuate with the value of their assets.

The flexible trust alternative: Like the fixed payment trust, the *charitable remainder unitrust* establishes a gift that returns an income. But unlike the annuity trust, the income from a unitrust may fluctuate over time.

When the plan is created, you decide the percentage the trust will pay (at least 5%). When the value of the trust increases, more income is received. The income will be less if the value of trust assets declines.

Income tax benefits are similar to those provided by the charitable remainder annuity trust. See the Alexander example on Page 5.

Probate and estate tax savings

The assets given through the use of each of the plans described in this booklet are not considered part of one's probate estate and are not subject to estate tax unless payments continue for the life of a person other than a spouse.

Other ways to give

There are a number of other ways to make significant charitable gifts as part of your financial and estate planning.

Examples include gifts through a will or revocable living trust, gifts of life insurance policies (or all or part of their proceeds), remainders of retirement plan accounts, and gifts of real estate that allow you to retain lifetime use for yourself and your spouse and/or other loved ones.

The gift of a lifetime

As we can see, through careful gift planning, it can be possible to make the "gift of a lifetime" while enjoying the knowledge that your needs, as well as your family's, have been met in full.

If you are interested in any of the ideas discussed here, we will be pleased to supply more information upon request. Or you may wish to share this booklet with your financial advisors. They will find the following section of particular interest.

Technical Advisory Section

The following information and references to other resources are provided for those who assist you in your gift, estate and financial planning.

General tax information

- Charitable gifts may be deducted in one year up to 60% of a donor's adjusted gross income (AGI) for gifts of cash. The limit is 30% of AGI for gifts of appreciated property. Gift amounts in excess of AGI limits may be deducted in as many as five succeeding tax years. See Internal Revenue Code section 170(d)(1)(A).
- When a gift plan is funded with an appreciated asset (securities or real estate, for example) held long term, the donor generally receives a charitable deduction based on the current fair market value of the asset. Special rules apply if an asset has been subject to certain types of depreciation or if it is not a capital asset. See IRC sections 170(e)(1)(A), 1250(a) and 1250(b).
- If the appreciated asset consists of tangible personal property which the organization does not use in a manner related to its exempt purposes, the deduction will be limited to basis. See IRC section 170(e)(1)(B).

Charitable gift annuities

A gift annuity is a contract between the donor and a charitable organization. Under the gift annuity contract, the donor transfers cash (or other acceptable property) to the organization, which agrees to pay a specified annuity. The annuity may be payable for one or two lives. See IRC section 514(c)(5).

Charitable deduction and taxation of payments: A charitable deduction is allowed for the difference between the amount used to establish the annuity and the initial present value of the annuity. See Regulation section 1.1011-2.

In general, part of each annuity payment is taxed to the annuitant as ordinary income. The remainder is tax free as a return of investment for a period of time, after which the payments are fully taxed. See IRC section 72(b)(2).

Capital gains reporting: When an individual funds a gift annuity with appreciated property, he or she must report capital gains (as determined under the bargain sale rules) along with any ordinary income received with respect to the gift annuity. If the annuity payments are made only to the donor or to the donor and a survivor, and if the annuity is nonassignable, the reportable gain may be spread ratably over the donor's life expectancy. In other cases, a portion of the gain must be reported in the year of the gift. See Reg. section 1.1011-2.

The ability to report a portion of income received from a gift annuity as capital gain income may be especially attractive to those whose ordinary income is taxed at rates that are significantly higher than capital gain income.

Estate and gift tax considerations: If the gift annuity is for the life of someone other than the donor (including a survivorship annuity), the present value of the annuity (determined at its inception) is subject to gift or estate taxation. See IRC section 2039. An annuity payable to the donor's spouse, however, qualifies for the gift or estate tax marital deduction. See IRC section 2056(b) and the regulations thereunder. Given increases in exemption amounts, federal gift and estate taxes are no longer a consideration in most cases.

Charitable remainder trusts

A *qualified* charitable remainder trust is generally exempt from income taxes, and gifts to such a charitable remainder trust typically qualify for a charitable deduction. See IRC section 664 for definitions.

There are two types of qualified charitable remainder trusts: the *annuity trust* and the *unitrust*. Both must qualify as valid trusts under applicable local law, and both must meet specific requirements. Income may be paid to the donor annually, quarterly or at other intervals.

Annuity trusts: A charitable remainder annuity trust pays out a fixed dollar amount each year, at least 5% of the initial fair market value of trust assets. The annuity payments are paid out of income first and then, to the extent necessary, out of principal. Trust income in excess of the required annuity payout must be accumulated and added to principal or be distributed to a qualified charity. See IRC section 664(d)(1).

Unitrusts: A charitable remainder unitrust each year pays out an amount generally equal to a fixed percentage—at least 5%, as selected by the donor—of the value of trust assets for the particular year. The trust assets are commonly valued, as directed by the trust agreement, on the first business day of each taxable year.

A unitrust may also be designed to pay out whichever is less: its net income for the year or the specified fixed percentage amount. This is commonly called a *net income unitrust.*

With a net income unitrust, the trust agreement may provide that for years in which trust net income exceeds the specified unitrust amount, the excess income may be used to make up for past years in which trust net income was less than the specified unitrust amount. This type of unitrust is known as a *net income unitrust with a makeup (or catch-up) provision.* See IRC section 664(d)(2).

A net income unitrust (with or without a makeup provision) is ordinarily used when the charitable remainder trust is to be funded with unimproved real estate or another type of asset that produces relatively little (or no) income.

Flip unitrusts: So-called *flip unitrusts* are trusts designed to start out as net income or net income with makeup unitrusts, which “flip” to become straight-payout unitrusts following some triggering event.

The triggering event generally must be an event outside the control of the trustee or any other person. Permissible triggering events include marriage, divorce, birth or death. The sale of an unmarketable asset is also a permissible triggering event. Impermissible triggering events include the sale of a marketable asset or a request from the donor or any other person or entity that the trust flip. See IRC section 664 for additional information.

Payout and deduction limitations: Unitrust or annuity trust payments may not exceed 50% of the initial amount contributed or 50% of the annual value of trust assets, and the charitable deduction amount must be at least 10% of the amount transferred to fund the trust. See IRC section 664.

Specimen provisions: To aid drafters of charitable remainder trust agreements, the IRS has issued specimen provisions to be included in such agreements. See Rev. Proc. 2003-53 through 2003-60 and Rev. Proc. 2005-52 through 2005-59. Visit www.irs.gov for additional guidance.

Charitable remainder trusts for a term of years: An annuity trust or unitrust may be set up for a specified number of years, not to exceed 20. It is also possible to specify certain time periods based on one or more lives. See IRC section 664(d).

Tax considerations: When the trust is created, a current tax deduction is allowed for the value of the charitable remainder interest (except in particular situations involving funding the trust with tangible personal property (see IRC section 170(a)(3)). The method of computing the deduction is described in Reg. section 1.664-4.

If an individual establishes a charitable remainder trust for his or her life, the trust assets will be included in his or her gross estate under IRC section 2036. The amount included, however, will "wash out" as an estate tax charitable deduction under IRC section 2055. A surviving spouse's interest in a qualified charitable remainder trust qualifies for the estate tax marital deduction. See IRC section 2056(b)(8).

There is a four-tier system of attributing ordinary income, capital gain, tax-free income and corpus to the trust payout. See IRC section 664(b) and IRS Notice 98-20.

In Letter Ruling 9015049, the IRS ruled privately that a trust cannot be a qualified charitable remainder trust if any trust income (which includes realized capital gain) is used to pay a mortgage debt for which the donor is personally liable. There are, however, ways to use property subject to such a mortgage to establish a charitable remainder trust. The most obvious way is for the donor to pay off the mortgage before transferring the property to the trust.

Wealth replacement trust

A powerful technique that can be used in connection with gift annuities, charitable remainder trusts and other life income gift plans is for the donor to "replace" the asset he or she gives away by using life insurance on his or her life.

Life insurance may be purchased using the income received from the gift plan, the immediate tax savings generated by the gift plan or some combination of both. In many cases, the life insurance is owned by and payable to an irrevocable insurance trust—a so-called *wealth replacement trust*. This can help ensure that the insurance proceeds will be free from estate taxation.

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