29 No. 1 Ohio Prob. L.J. NL 9

Ohio Probate Law Journal | September/October 2018
Volume 29, Issue 1
Probate Law Journal Of Ohio
By Patrick J. Saccogna, Esq. [a0]

Charitable Giving Under The New Tax Laws

Introduction

The tax act formerly known as the Tax Cuts and Jobs Act, an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the "2017 Act"), [1] includes many changes to the tax laws that fundamentally alter the tax landscape for just about everyone. These changes will greatly impact charitable giving for donors. It is therefore imperative for estate planners to learn the new rules, understand the new paradigms resulting from these rules, and be able to help donors implement charitable giving tools and strategies that are tailored to donors' unique individual circumstances and goals and objectives.

Most of the 2017 Act's changes affecting individuals are *temporary* in nature, because they are slated to be in effect only from January 1, 2018, through December 31, 2025. Then, on January 1, 2026, the tax laws in effect on December 31, 2017, magically come back to life and supplant the provisions of the 2017 Act. Of course, the tax laws could change again sooner than 2026 if, for example, we see another tax reform project pass (the Tax Cut and Jobs Act v. 2.0, anyone?) during President Donald Trump's tenure and/or if we see a new President emerge from the 2020 election.

This article will summarize some of the major new tax law provisions that affect charitable giving, and identify and discuss several key charitable giving planning opportunities for donors under the new tax law provisions.

Major New Tax Provisions That May Affect Charitable Giving

Federal transfer taxes. The 2017 Act *increases* the **federal estate and gift tax basic exclusion amount** to $10 million (with inflation adjustments intact, and going forward at the "Chained CPI"), effective for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026, and *retains* the maximum tax rate of 40% for federal estate and gift taxes. For 2018, the federal estate and gift tax basic exclusion amount is $11.18 million per individual, or a combined $22.36 million for married couples. [2] In addition, the federal gift tax annual exclusion amount increased to $15,000 per donee for 2018, its highest level ever. [3]

The 2017 Act similarly adjusted the federal generation-skipping transfer ("GST") tax. As a result, for 2018, the **federal GST tax exemption amount** is $11.18 million per individual, or a combined $22.36 million for married couples. [4]

Despite its dramatically more generous federal estate, gift, and GST tax exemption amounts, the 2017 Act *retains* the longstanding **fair market value basis step-up (-down) rules** for appreciated (depreciated) assets passing from a decedent at the decedent's death. [5]

Federal income taxes. The 2017 Act has brought only relatively modest changes on the income side of the equation. The 2017 Act (i) modestly *reduces* **individual income tax rates** (*e.g.,* the top rate is now 37%, down from 39.6%) while modestly *raising* the thresholds of the seven tax brackets, and (ii) *maintains* the **capital gains tax rates** (*e.g.,* with a top rate of 23.8%, including the 3.8% Medicare tax, which was retained) and breakpoints that existed under prior law. The

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

2017 Act also reduces the top corporate income tax rate from 40% to 21%, and sets forth a new 20% deduction for the qualified business income of pass-through entities such as partnerships, limited liability companies, and Subchapter S corporations. This deduction lowers the top personal rate for qualifying individuals from 37% to 29.6%, but limitations apply with respect to certain "personal service businesses."

The 2017 Act *increases* the **standard deduction** to $24,000 (up from $12,700 in 2017) for married individuals filing jointly and surviving spouses, $18,000 for unmarried individuals with at least one qualifying child, and $12,000 for single filers (up from $6,350, or $9,350 for heads of household, in 2017), for tax years beginning after 2017. But these increased standard deduction amounts are scheduled to expire after December 31, 2025.

For tax years beginning after December 31, 2017, and before January 1, 2026, the 2017 Act *suspends* (i) the **deduction for personal exemptions**, (ii) all **miscellaneous itemized deductions** that are subject to the 2% floor (*e.g.* unreimbursed employee expenses, tax return preparation fees, and other expenses paid to produce or collect income), and (iii) the **overall ("Pease") limitation** on itemized deductions.

The 2017 Act *reduces* the **mortgage interest deduction** to interest on $750,000 of acquisition indebtedness interest for debt incurred after December 15, 2017 (with the prior law's $1 million limitation *remaining* for older debt), until December 31, 2025. It also *suspends* the mortgage interest deduction for interest on home equity indebtedness for tax years beginning after December 31, 2017, and before January 1, 2026.

The 2017 Act provides that individual taxpayers may *elect to deduct* **state and local** sales, income, or property taxes up to $10,000 ($5,000 for a married taxpayer filing a separate return) for tax years beginning after December 31, 2017, and before January 1, 2026, and may *deduct* state, local, and foreign property taxes and state and local sales taxes when paid or accrued in carrying on a trade or business.

The 2017 Act *increases* the AGI limitation on **charitable contributions** from 50% to 60%, effective for *cash* contributions made in tax years beginning after December 31, 2017, and before January 1, 2026. It also permanently *repeals* the 80% deduction for contributions made for university athletic seating rights, effective for contributions made after December 31, 2017, and *repeals* the exception to the requirement that the taxpayer obtain a contemporaneous written acknowledgement for charitable contributions equal to or greater than $250 when the donee organization files the required tax return, effective for contributions made in tax years beginning after December 31, 2016.

The 2017 Act *limits* the **personal casualty losses** (*i.e.,* fire, storm, shipwreck, *etc.*) itemized deduction for property losses (not used in connection with a trade or business or transaction entered into for profit) to apply only to losses incurred as a result of federally-declared disasters, effective for losses arising in tax years beginning after December 31, 2017, and before January 1, 2026. The 2017 Act also *reduces* the **medical expense deduction** floor to 7.5% (from 10%) of AGI (for tax years 2017 and 2018 only), and *eliminates* the deduction as an alternative minimum tax (AMT) preference item.

The 2017 Act *eliminates* the above-the-line deduction for **alimony payments** for the payer, and *excludes* alimony payments from the gross income of the payee, for divorce decrees, separation agreements, and certain modifications entered into after December 31, 2018. The 2017 Act *suspends* the **moving expenses deduction** (*except for* active duty members of the armed forces who are required to move on account of a military order and incident to a permanent change of station), for tax years beginning after December 31, 2017, and before January 1, 2026.

General Effects of New Tax Laws on Charitable Giving

First, a look at "core" giving. Before analyzing the effects of the new tax laws on charitable giving, we must remember that the non-tax benefits that one realizes through charitable giving can be manifold. Individuals often enjoy a sense of inner peace and personal satisfaction by giving to causes that they believe in. Donors can leave a family or community legacy via charitable giving. Depending on the type of charitable giving mechanism employed, donors can retain an

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

income stream from and/or control over the gifted assets. And, in many cases, they can achieve federal income, gift, and/or estate tax deductions. The bottom line is that individuals who make a habit of charitable giving give, at some core level, "from the heart." Thus the questions become not so much whether or not, but how much and by what means?

Effects of transfer tax law changes. The 2017 Act's doubling of the federal estate and gift tax exemptions (resulting in $11.18 million per individual in 2018, or $22.36 million for married couples in 2018) reduces the number of individuals who are subject to these taxes to a very small fraction of 1% of the American population. Considering that there are essentially only three "buckets" (*i.e.*, family and friends, charity, and the IRS) into which an individual may drop assets at death, these tax law changes may motivate fewer people to give to the charity bucket at death, because they no longer need to do so in order to avoid the federal estate tax. So, for example, a married couple employing an "exemption cap" strategy with remainder to charity, may rework the plan to substantially reduce or drop altogether their testamentary charitable gifts. Or they could rework their plans, as discussed later, to implement charitable giving devices designed to afford charitable *income* tax deductions.

Effects of income tax law changes. The relatively modest reduction in the individual income tax rates and the changes in the tax bracket thresholds under the 2017 Act should not, in and of themselves, have a major impact on charitable giving.

The combination of the 2017 Act's nearly doubling of the standard deduction with the suspension or scale back of so many other income tax deductions has the charitable community concerned, and rightly so. This is because charities have traditionally relied heavily on a very large number of relatively small annual cash gifts made by itemizers. Under prior law, according to a January 2018 study by the Tax Policy Center, about 25% to 30% of American taxpayers, or about 47 million people, could itemize their deductions and thereby deduct their charitable contributions.[6] Because of the new tax laws, however, it is estimated that the percentage of American taxpayers eligible to itemize their deductions will drop to about 10%, or about 19 million people.[7] Taxpayers who are not eligible to itemize their deductions on account of the aggregate level of those deductions falling short of the standard deduction amount will simply claim the standard deduction (and thus *not* be able to deduct any part of their charitable contributions).

Charities are concerned that those taxpayers who can no longer itemize and thus can no longer deduct their charitable contributions will reduce the level of, or even eliminate entirely, their charitable contributions. Some in the charitable giving community have estimated that the 2017 Act, including the non-itemizers' loss of an income tax deduction for charitable gifts, will result in a reduction in total charitable giving between $13 billion to $24 billion annually.[8] Some tax experts, including regulatory staff at the IRS and Congressional Budget Office, believe that the annual cuts in charitable giving could be between $25 billion to $30 billion.[9] Ouch! So, that's the end of this article, correct? Well, not so fast.

Charitable Giving Planning Opportunities under the New Tax Laws

Current climate for charitable giving. Notwithstanding charitable organizations' concerns about a drop-off in annual charitable giving by non-itemizers and in testamentary giving by individuals who no longer have to worry about the federal estate tax, the new tax laws actually make charitable giving *more attractive* than under prior law for many high income, high net worth donors, as well as for some taxpayers not falling into that category.

Many taxpayers with higher incomes will seek to reduce their taxable income given the top federal ordinary income (and short-term capital gains) tax rates of 40.8% (when including the Medicare tax) and top federal capital gains tax rates of 23.8%. But don't forget to add in state income and capital gains taxes, particularly in high income tax states. Because state and local tax (SALT) deductions are generally limited to $10,000 annually,[10] and mortgage interest is typically static from year to year, taxpayers' only "flexible" income tax deduction strategy may be to create *charitable* income tax deductions!

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

For many taxpayers still able to deduct their charitable contributions for federal income tax purposes, these deductions have become *more valuable* (because they "cost" less) under the provisions of the 2017 Act for several important reasons. First, under the new tax laws, the effective combined federal and state income tax rates have actually risen for a large number of taxpayers in higher income tax states due to the 2017 Act's $10,000/$5,000 cap on the state and local income and property tax deductions. [11] Second, under the new tax laws, the marginal federal income tax rate has actually increased for individual taxpayers in the new $200,000 to $416,700 tax bracket. Third, the 2017 Act repealed the Pease limitation that would have otherwise decreased the amount of some taxpayers' charitable income tax deductions. Fourth, the 2017 Act raised taxpayers' AGI limitation for charitable contributions made in cash from 50% to 60%. Fifth, taxpayers' gifts of appreciated corporate stock, along with planned giving techniques employing appreciated corporate stock, have become more attractive because the 2017 Act lowered corporate tax rates, which will increase corporate profits and make such stock more valuable. The rise in the value of corporate stocks means more people will hold more highly appreciated assets. Thus, avoiding the now larger capital gains taxes on these now larger capital gains is even more important.

Shift towards income tax planning. Even under prior law, as a result of higher transfer tax exemptions, lower transfer tax rates, and with higher income tax rates, estate planners and their clients were shifting their focus away from transfer tax planning and towards income tax planning. That shift will only be exacerbated and expedited by the tax law changes of the 2017 Act.

Both tried-and-true and new-fangled charitable giving strategies are in play. In light of the changes to the tax laws brought by the 2017 Act, new charitable giving ideas are springing up and are ripe for consideration by estate planners and their clients. In addition, many existing charitable giving techniques are still viable or are even more attractive than before for many individuals.

Tried-And-True Planning Strategies for Charitable Giving Now

The IRA Charitable Rollover. Many high income individuals over age 70½ will not want to increase AGI and may not need the income from their IRAs. The Pension Protection Act of 2006 [12] birthed the IRA charitable rollover and its related rules. After extending these rules several times, Congress finally made them "permanent" via the Protecting Americans From Tax Hikes Act of 2015. [13]

The IRA charitable rollover permits a taxpayer who is over age 70½ to transfer up to $100,000 annually from the taxpayer's IRA directly to qualified public charities (including community foundations, but *not* including donor advised funds, supporting organizations, or private foundations). [14] This technique serves "double duty" by satisfying the donor's required minimum distribution ("RMD") for the year in question by the amount of the rollover. Married couples where each spouse has sufficient IRA assets could thus transfer up to $200,000 per year in charitable rollovers. (Note: the distribution must be made from an IRA, and not a 401(k), 403(b), H.R. 10, or other retirement plan.)

Importantly, the IRA charitable rollover essentially operates as an *"above-the-line"* (as opposed to itemized) income tax deduction for the donor, *even if* the donor would not otherwise be entitled to itemize deductions. This is because, with the rollover, the donor diverts otherwise taxable income directly to a qualified charity. Thus, the donor does *not* recognize taxable income when the donor directs his or her RMD directly to the charity. [15] This is particularly important for high tax bracket individuals who want to reduce their AGI and thus possibly avoid up to four different AGI thresholds that define a wealthy taxpayer. Such avoidance could further reduce income tax liability.

> EXAMPLE 1—IRA CHARITABLE ROLLOVER: Mary Doe's RMD this year is $100,000. Her income tax basis in the IRA is -0-. Her marginal federal income tax rate is 35%. She is eligible to itemize her deductions, but is only $40,000 short of hitting her 60% AGI limitation on cash contributions. With the IRA charitable rollover approach, Mary is able to have her IRA custodian drop off her $100,000 RMD

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

directly to her favorite charity, and thus *exclude* the $100,000 RMD from her taxable income, essentially as an *"above-the-line" income tax deduction*. (This approach also enables her to make additional charitable contributions of cash up to $40,000 and deduct them as *itemized deductions*.) Thus, Mary's net recognized taxable income on rollover is ***$-0-***, which nets her a federal income **tax liability** on the rollover of ***$-0-*** (*i.e.,* $-0- net recognized taxable income x 35% marginal rate), and a net **federal income tax savings** on the rollover of ***$35,000*** (*i.e.*, $100,000 of taxable income not recognized x 35% marginal rate, and *ignoring* the additional tax savings that would result if Mary took additional itemized deductions for additional charitable contributions of cash up to $40,000). Mary's net out-of-pocket cost of making the gift is ***$65,000*** (i.e., $100,000 gift less $35,000 tax savings).

EXAMPLE 2—NON-ROLLOVER APPROACH (WITH ITEMIZED DEDUCTION *PARTIALLY DENIED*): Same facts as Example 1, *except that* Mary receives her $100,000 RMD from her IRA, and then writes a $100,000 check to her favorite charity from her personal checking account with the resulting cash. With the non-rollover approach and as an *itemizer subject to the 60% AGI limitation for cash contributions (with another $40,000 of qualifying contributions)*, Mary recognizes $100,000 of taxable income when she receives her RMD, and then is entitled to only a $40,000 itemized deduction for her charitable contribution. (The remaining $60,000 unused deduction may be carried over for 5 years, subject to any applicable deductibility limitations in those years.) Thus, Mary's net recognized taxable income on the transaction is ***$60,000*** (*i.e.*, $100,000 gross recognized taxable income from RMD less her $40,000 itemized deduction), which nets her a federal income **tax liability** on the transaction of ***$21,000*** (*i.e.,* $60,000 net recognized taxable income x 35% marginal rate), and a net **federal income tax savings** on the transaction of only ***$14,000*** (*i.e.*, $40,000 itemized charitable contribution deduction x 35% marginal rate). Mary's net out-of-pocket cost of making the gift is ***$86,000*** (i.e., $100,000 gift less $14,000 tax savings).

Comparing Example 1 with Example 2, we see that Mary Doe, as an itemizer who has hit her 60% charitable contribution AGI limitation in the latter case, is much better off with the IRA charitable rollover approach than she is with the non-rollover, in this case by an impressive $21,000 of net federal income tax savings (*i.e.*, $35,000 less $14,000). Note that, taking as a further example the same facts as Example 1 except that Mary is a non-itemizer, her tax results would be the same as those in Example 1.

As shown by these examples, the IRA charitable rollover strategy is particularly useful for higher income taxpayers and non-itemizers. Planners should review with clients their income tax returns, investment allocations and financial plan, and estate plan documents in considering this strategy as part of a comprehensive wealth and estate plan.

Outright gifts of appreciated assets. Even in the aftermath of the 2017 Act, one of the largest tax advantages in charitable giving today remains the "double benefit" that donors receive when they gift appreciated assets, say, publicly traded stock, in lieu of cash. This is particularly true given the very high current valuations of equities and real estate. Note that such gifts are subject to lower AGI limitations (30% of AGI) than cash contributions (60% AGI), and that excess deductions may be carried forward for up to five years. While cash gifts reduce the donor's spending capital, donations of appreciated property do not.

When a donor who is eligible to itemize deductions makes a gift to charity of publicly traded appreciated stock held for more than one year, the donor (i) is entitled to take a *charitable income tax deduction* equal to the fair market value of such stock at the date of the gift, [16] and (ii) *avoids all capital gains taxes* on such property. (The charity generally also avoids tax on its future sale of the donated appreciated property, because it is a tax exempt entity. [17]) For highly

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

appreciated stock, this double tax benefit—charitable income tax deduction *plus* capital gains tax avoidance—rivals the tax advantages of the IRA charitable rollover!

What if the donor cannot itemize deductions? If the donor's total itemized deductions are less than the applicable standard deduction, the donor will take the standard deduction and thus not be able to enjoy a charitable income tax deduction for his or her gifts (whether of appreciated property or cash) to charity. However, if the non-itemizer donor gives the appreciated property to charity, he or she would nevertheless be able to avoid all capital gains tax on the sale of the gifted appreciated property, which means that a charitable gift of appreciated stock would still be better tax-wise than a charitable gift of cash of equal value to the stock.

The Charitable Remainder Trust. With more sophisticated planned giving, donors are not only able to avoid capital gains taxes and take a charitable income tax deduction, but they are also able to retain for life the income (often in the form of a unitrust interest or an annuity) from the gifted assets. Kind of like having your cake and eating it, too! The charitable remainder trust has been around for decades and is still just as or even more viable under the 2017 Act as it was under prior law.

The charitable remainder trust, which can be designed as either a charitable remainder unitrust ("CRUT") or a charitable remainder annuity trust ("CRAT"), is ideal for the donor who wishes to gift appreciated property to charity, avoid the capital gains tax on the sale of the property by the trust, achieve an immediate charitable income tax deduction, and receive a retirement-like cash flow from the gifted property for the donor's remaining lifetime. [18] The entire value of the gifted property after its sale by the tax-exempt trust (as opposed to just the net after-tax sales proceeds, as with a sale by the donor) will be working to produce the income for distribution to the donor.

> EXAMPLE 3—CRUT: John and Mary Doe, whose combined federal and state capital gains tax rate is 30%, and whose combined federal and state marginal income tax rate is 40%, transfer an investment property worth $1 million and having a tax basis of $100,000 to a new charitable remainder unitrust (CRUT) that pays a 5% unitrust interest to John and Mary for their joint lives. The CRUT sells the property, which results in zero tax liability to the CRUT, John, and Mary, and an income tax savings of $270,000 (*i.e.*, $900,000 gain excluded x 30% combined capital gains tax rate). John and Mary also are entitled to a charitable income tax deduction of $400,000, which produces an income tax savings of $160,000 (*i.e.,* $400,000 deduction x 40% marginal tax rate), so that their total current income tax savings is $430,000 (*i.e.,* $270,000 + $160,000). In addition, they may ultimately receive about $1.7 million in unitrust payments (*i.e.*, $50,000+ annually, assuming the assets appreciate) over their 30-year joint life expectancy.

Beware of the Dog, er, … Substantiation Requirements! Donors can give away appreciated assets *other than* publicly traded corporate stock to charity, either outright or in trust, assuming that the charity will accept such assets. But, in order for donors to be able to deduct such gifts for federal income tax purposes, they must comply with any applicable qualified appraisal and other substantiation rules. [19] These rules are cumbersome and complex, and it is easy for donors to violate them and lose the deduction. For example, any required receipt or acknowledgement must not only be accurate, but also timely (usually contemporaneous). A long list of recent tax court cases suggests that the IRS is winning in its quest to deny deductions for even seemingly trivial failures to meet the substantiation requirements. [20]

New-Fangled Planning Strategies for Charitable Giving Now

"Bunching" charitable contributions. Perhaps the 2017 Act's largest impact on charitable giving will be that the higher standard deduction will reduce the number of itemizers, which, in turn, will result in fewer individuals having the ability to take a charitable income tax deduction for their charitable contributions. At first blush, this looks like it will

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

result in fewer people making charitable contributions and/or many people reducing the magnitude of their charitable contributions and thus fewer dollars going to charitable organizations, right? Enter charitable "bunching."

The idea of *bunching charitable contributions* involves individuals who cannot otherwise itemize deductions and thus cannot otherwise deduct their normal level of charitable gifts this year (or perhaps in any reasonably foreseeable future tax year while the provisions of the 2017 Act are effective). Instead of "wasting" their deductions or deciding to stop their charitable giving, however, these same individuals, if they have the financial flexibility, could "bunch" several years' worth of their normal level of charitable gifts into a "target" year in order to itemize their deductions in such target year. They could then take a large charitable income tax deduction in the target year and avoid wasting such deductions in the off years when they take the standard deduction. This plan of alternating years between making larger than normal charitable gifts and claiming itemized deductions, on the one hand, and skipping the gifts altogether and taking the standard deduction, on the other, could continue for many years.

Widespread bunching of charitable contributions, of course, could make it difficult for charitable organizations to plan from year to year. A Donor Advised Fund ("DAF"), however, could be utilized to allow donors to bunch their contributions to the DAF, take an immediate charitable income tax deduction, and then request the DAF to "normalize" the payouts to charity.

> EXAMPLE 4—NON-ITEMIZER's CHARITABLE GIFTS (*WITHOUT* BUNCHING): John and Mary Doe are married. Their marginal federal income tax rate is 35%. They normally give $10,000 cash per year to their favorite charitable organization and claim the gift as an itemized deduction on their joint federal income tax return. Under the provisions of the 2017 Act, however, they will *not* be able to deduct a charitable gift of $10,000 on their 2018, 2019, and 2020 federal income tax returns, respectively, because the aggregate amount of their itemized deductions for those years (no mortgage interest deduction, because they have no mortgage, $10,000 charitable gifts, and $10,000 of SALT deductions) will fall short of the standard deduction of $24,000. John and Mary decide to make their normal $10,000 charitable gift in each of 2018, 2019, and 2020 anyway, and take the standard deduction for each of those tax years. While John and Mary's favorite charity will still benefit from their generosity, John and Mary will not from an income tax standpoint. As a result of *not* bunching their charitable gifts and taking the standard deduction in each of 2018, 2019, and 2020, John and Mary will have wasted an itemized charitable income tax deduction of $10,000 in each of those three years, for a total wastage of $30,000, which will cost them a $3,500 (*i.e.,* $10,000 lost deduction x 35% marginal rate) tax benefit on each of their 2018, 2019, and 2020 federal income tax returns. Thus, John and Mary's total **loss of tax benefit** is **$10,500** (*i.e.,* $3,500 per year x 3 years), and the **net "cost" of their gifts** would be **$30,000** (*i.e.*, $10,000 per year x 3 years).

> EXAMPLE 5—NON-ITEMIZER's CHARITABLE GIFTS (*WITH* BUNCHING): Same facts as Example 4, *except that* John and Mary decide to "bunch" three years' worth of their charitable gifts, or $30,000 (*i.e.,* $10,000 per year x 3 years), into 2018 and then skip making charitable gifts in 2019 and 2020. Here, both the charity (in 2018, but not 2019 or 2020) and John and Mary benefit. As a result of the bunching approach, John and Mary will be able to deduct the entire $30,000 charitable contribution on their 2018 federal income tax return as an itemized deduction, and thus receive an immediate **tax benefit** of **$10,500** (*i.e.,* $30,000 deduction x 35% marginal rate), and the **net "cost" of their gifts** would be **$19,500** (*i.e.*, $30,000 gift less $10,500 tax benefit). Furthermore, John and Mary are able to avoid wasting charitable gift deductions in the off years (2019 and 2020) when they make no such gifts and take the standard deduction.

> EXAMPLE 6—NON-ITEMIZER's CHARITABLE GIFT (*WITH* BUNCHING *AND* DAF): Same facts as Example 4, *except that* John and Mary make their $30,000 charitable gift to a DAF in 2018, and the DAF then distributes $10,000 of the gift to John and Mary's favorite charity in each of the years 2018,

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

> 2019, and 2020. The tax results are the same to John and Mary as in Example 4, but this time, the charity is "normalized" in that it gets the same $10,000 per year that it was used to receiving from John and Mary in prior years.

Note that the concept of bunching could also be used in connection with the donor's funding of a *charitable remainder trust* or *charitable gift annuity*. Of course, bunching does not have to be done over a three-year period, but could also work in two-year periods or periods even longer than three years.

***Non-Grantor Trust for charitable giving and IRC Section 642(c): "Super-Bunching"*?!** Some advisors are suggesting that donors use non-grantor trusts that would facilitate charitable giving in lieu of or in combination with the bunching of charitable gifts in situations where individual donors are taking the standard deduction and cannot deduct their charitable contributions.

IRC Section 642(c). IRC Section 642(c) sets forth what is known as the charitable *fiduciary* income tax deduction. This subsection of the Internal Revenue Code generally permits trusts and estates to deduct a charitable contribution for income tax purposes, *but only if* (a) the contribution is made out of the gross income (*i.e.*, ordinary income *and* capital gains) of the trust, and (b) the governing document (the trust instrument or will) expressly authorizes the charitable contribution.[21] Because of the gross income requirement, the fiduciary must trace the charitable contribution directly to its source of income. The tracing requirement of IRC Section 642(c) is the only one of its kind within the fiduciary income tax rules. This makes the charitable fiduciary income tax deduction unique, and it is significantly different than the individual charitable income tax deduction or the corporate charitable income tax deduction.

Non-Grantor Trust and the IRC Section 642(c) fiduciary charitable income tax deduction together. The idea here is that an individual would create and fund a non-grantor trust that would permit the trustee to make discretionary distributions among the grantor's chosen family members and/or other non-charitable beneficiaries and favorite charitable organizations. Because the trust is structured as a non-grantor trust, it would be a taxable entity. As such, the trust would be entitled to take an IRC Section 642(c) fiduciary charitable income tax deduction for amounts that the trust distributes to charity from the gross income (*i.e.*, ordinary income and capital gains) of the trust.[22] This approach would get around the limitations on the grantor himself or herself being able to deduct charitable contributions. Furthermore, the trust's distributable net income ("DNI") would be reduced by such deduction, thus minimizing any DNI carryout to the non-charitable beneficiaries with respect to distributions made to them.

Additionally, the grantor of the trust has no income tax on the earnings of the trust and, because he or she gifted the assets to the trust, the assets' earnings are no longer appearing on the grantor's personal income tax return. This effectively saves the grantor state and federal income tax on the trust's income. That's essentially the same as an income tax charitable deduction that is not otherwise available to the grantor.

Caveat for in-kind charitable contributions. The Tenth Circuit this year held in a case of first impression that the IRC Section 642(c) fiduciary charitable income tax deduction for *in-kind* charitable contributions from a trust are limited to the trust's *adjusted basis* in the contributed assets (as opposed to the assets' higher fair market value).[23] Thus, it would be well for the trustee of the non-grantor trust to avoid making in-kind distributions to charitable beneficiaries.

> EXAMPLE 7—NON-ITEMIZER's NON-GRANTOR TRUST: Same facts as Example 4, *except that* John and Mary decide to set up a non-grantor trust for the benefit of their children and their favorite charitable organization, and hope that the trust is able to make annual distributions to the charity of about $10,000 per year from the gross income of the trust. The trustee is given broad discretion to distribute the income and principal of the trust among all of these beneficiaries. The trust is entitled to take an IRC

Section 642(c) fiduciary charitable income tax deduction for any distributions it makes to the charity from the gross income of the trust. If John and Mary transfer about $250,000 or so of marketable securities to the trust in 2018, they could reasonably expect that the principal of the trust would produce about $10,000 of gross income (ordinary income and capital gains) per year. John and Mary hope that, by taking this approach, the trust will be able to produce about $10,000 of annual gross income, distribute that income to the charity, and take an IRC Section 642(c) fiduciary charitable income tax deduction for the $10,000 distribution, all while leaving virtually no DNI to be passed out to the children. Here again, the charity and John and Mary may benefit. As a result of using the non-grantor trust approach, John and Mary will not waste any charitable deductions in taking the standard deduction, while enabling the trust to take an income tax deduction for the distributions to charity made from the gross income of the trust. In addition, John and Mary are able to remove assets from their gross estate for federal estate tax purposes in a beneficial way for their children, and to avoid paying income taxes on the earnings of such assets akin to enjoying a charitable income tax deduction after all.

Paradigm shifts for "planned gifts" and the rise of "blended gifts." Donors often make substantial charitable bequests (often called "planned gifts") as part of their estate plans, particularly if they believe such gifts will help reduce or even eliminate a federal estate tax liability. A new paradigm, however, exists for the many individuals who no longer expect to pay a federal estate tax because of the gargantuan federal estate tax exemption amounts now in play, and because they do not expect to survive the December 31, 2025 sunset date for such exemptions. For these donors, the federal estate tax charitable deduction is now completely unnecessary to help them achieve a zero federal estate tax result.

This new paradigm brings about the following potential shifts in testamentary (and lifetime) charitable giving:

"Proxy" bequests to family members. First, instead of these donors simply leaving large charitable bequests to charity at death in order to avoid a federal estate tax that will not ultimately result on account of the sky-high federal estate tax exemption amount, they should consider *leaving the bequests to family members* who could then use the bequests to make lifetime charitable gifts of their own that they can deduct as itemized deductions for federal income tax purposes. This approach could be particularly useful if the family has common goals in charitable giving.

"Blended" gifts. These donors should also consider working with the charities to develop a "*blended" gifting program* that would utilize *both* substantial lifetime gifting techniques *and* planned gifts taking effect at death, allowing the donors to achieve lifetime charitable income tax deductions and to benefit charity during their lifetime and at death.

Funding planned gifts. With respect to *planned gifts,* or those taking effect at a donor's death, the donor should look first to "bad" assets like IRAs and other retirement assets as the assets to be given to charity, so that he or she can preserve the "good" assets (consisting of non-retirement assets) for the family. This is because the bad assets carry with them a built-in income tax liability, whereas the good assets do not. (The charitable organization, which is tax exempt, will typically not have to pay the income tax on the bad asset, to boot.)

Beneficiary designations. Donors in this category should also consider changing their *beneficiary designations* to designate charity as the primary beneficiary of all or part of their (i) life insurance policies that are no longer needed to provide the estate with liquidity to pay federal estate tax (because there will be no federal estate tax), and (ii) retirement accounts, particularly if sufficient non-retirement assets can be used to fully fund the intended gifts to family members.

EXAMPLE 8—TESTAMENTARY CRUT: Mary Doe creates in her estate plan an unfunded testamentary CRUT that is designed to pay a 5% unitrust amount to her surviving children for a term of 20 years after her death, with the remainder over to her favorite charities. She names the trustee of the unfunded CRUT as the primary beneficiary of her IRA or other qualified retirement plan account. After

 © 2018 Thomson Reuters. No claim to original U.S. Government Works.

> Mary's death, the retirement account is paid out to the CRUT, and the charity does not pay income tax on the remaining assets it receives after the 20-year term.

Charitable lead trust ("CLT"). The *charitable lead trust*, or CLT, is still a viable option in situations where (i) the donor expects his or her estate to owe a federal estate tax liability, (ii) the applicable federal rate ("AFR") is low, and (iii) the donor expects the assets funding the trust to appreciate. In this case, the CLT would allow the senior generation of the family to continue their philanthropic goals for a term of years and achieve federal income tax deduction(s) in so doing, while encouraging junior family members to become involved.

Bequests of income (instead of property). Donors should consider changing charitable bequests of assets to *charitable bequests of income*. Because the gift of an asset from an estate may no longer make a difference from a federal estate tax perspective, the donor could change the nature of the gift so that it will make a difference from an income tax perspective. Remember that estates are separate taxpayers and thus must pay income taxes on their earnings. They can also deduct expenses, including charitable gifts, without the limitations that individual taxpayers face.

> EXAMPLE 9—BEQUEST OF INCOME: John Doe's Will provides for a bequest that leaves $100,000 of cash to ABC Charity, a nice gift for the charity, but tax inefficient for John's estate, because the value of the estate is well under the federal estate tax exemption amount and thus the bequest is not needed to avoid the federal estate tax. Realizing this, John rewrites his will to provide for a bequest that leaves the first $100,000 of the *income* of the estate to ABC Charity. The result of this change is the same benefit for the charity, but a much better result for John's estate, because now, the $100,000 bequest will be deductible on the estate's income tax return, saving the heirs income taxes.

Tapping those growing DAFs! With or without bunching, remember that, under current law, there are no timing requirements for distributions from DAFs to charity. Thus, the timing of such distributions are currently within the discretion of donors and fund managers. DAFs held about $85 billion in total assets in 2016, and now hold about $150 billion. That number is expected to keep rising, and it is in no small part due to the fact that *contributions to* DAFs far outpace *distribution from* DAFs. DAFs that are affiliated with commercial money managers, like Fidelity and Vanguard, are now among the largest charitable organizations in the country.

Thus, even if a donor who has a DAF cannot itemize deductions or otherwise deduct any charitable contributions in a given tax year, that donor could nevertheless request his or her DAF to make distributions to charity in that same tax year. Employing this approach would achieve the donor's non-tax charitable giving goals and objectives with absolutely no tax or other downsides to the donor!

This is why the relevance of charitable giving should be a more motivating factor within the DAF environment, without compromising the tax planning effectiveness that have made DAFs so attractive in the first place. Accordingly, it seems appropriate for charitable organizations to professionally approach these donors and large DAF managers and ask for additional available funding through DAF distributions to help them meet their mission now that the "rainy day" has arrived with the new tax laws.

***Family business philanthropy*.** Individual donors who own family businesses, of course, can use their businesses as charitable giving vehicles. These businesses could consider making outright gifts of cash or appreciated property, gifts to DAFs, gifts via family foundations, and gifts via trusts.

A donor who gives via the family business can (i) demonstrate the donor family's values, often the connective tissue of the family business, to the community and marketplace, (ii) encourage multiple generations of the family to become involved in and make their mark on the charitable aspect of the family business, which can strengthen the bonds between family members across generations, and (iii) complement the family's overall wealth management strategy (*e.g.*, impact investing, tax management investing, *etc.*).

Gifts of life insurance policies: look before you leap. Gifts of life insurance, like under prior tax law, are doable but not necessarily recommended. Advantages of a gift of a life insurance policy include relative simplicity, preservation of cash, making use of an otherwise unneeded asset, and the potential to fund the premium payment via gifts of appreciated property to charity. Disadvantages include limitations on income tax deductibility (including valuation at the *lesser of* the FMV or the adjusted cost basis of the policy), potential future tax law changes, acceptability of life insurance as a gift, applicability of valuation/substantiation requirements if value of policy exceeds $5,000), ongoing administrative issues, and tax benefits of tax-free cash value buildup and tax-free death benefit are not needed by (and thus "wasted" on) charity.

Keeping watch on positive charitable giving trends. Charitable organizations see a number of positive ongoing charitable giving "trends" that could soften the blow of some of the negative tax law changes of the 2017 Act, including (a) the increase in *issue-related giving* (aka "rage philanthropy") across the political spectrum, as large numbers of donors are giving to organizations that reflected their deepest beliefs, (b) the growth in *giving circles*, where individuals and groups combine their resources in charitable giving, (c) *impact investing* aimed at the double bottom-line of financial return and social impact (especially considering the nearly $1 trillion of wealth currently held by foundations and DAFs), and (d) simple, but powerful *volunteerism*.

The "Golden Age" of philanthropy. Here's another important trend: the level of annual charitable giving just keeps rising. A whopping $400 billion was given to charity in 2017, which was the highest figure in history, and yet this number only represents about 2.1% of the United States' GDP.[24] A recent article on the subject suggests that the charitable giving inflection point will not be reached until annual charitable giving reaches 7% to 10% of GDP, and that, therefore, we are only just now in the beginning of the "Golden Age of Philanthropy."[25]

Conclusion

The 2017 Act includes a number of federal transfer tax and federal income tax changes that substantially affect charitable giving for not only high income, high net worth individuals, but also for many people who fall outside those categories. Charitable giving will remain important for these individuals, and become even more valuable (less costly) for some. Donors will have at their disposal a litany of both tried-and-true charitable giving techniques and new-fangled options that are well-tailored to take advantage of the new tax laws. Estate planners will want to have a command of these techniques and help bring them to bear to help clients meet their unique goals and objectives.

Westlaw. © 2018 Thomson Reuters. No Claim to Orig. U.S. Govt. Works.

Footnotes

a0 Thompson Hine LLP
Cleveland, Ohio
Based on presentation by the author at the 2018 Cleveland Metro Bar Assn. Hot Topics Program.

1 P. L. 115-97, 12/22/17.

2 Rev. Proc. 2018-18.

3 Rev. Proc. 2017-58, as amended by Rev. Proc. 2018-18.

4 Rev. Proc. 2018-18.

5 I.R.C. § 1014.

6 *See* Rubin, "Charity Funds Take Off as Tax Law Reshapes Giving," *Wall Street Journal* (February 1, 2018).

7 *Id.*

8 *See, e.g.,* Brill and Choe, "Charitable Giving and the Tax Cuts and Jobs Act," *American Enterprise Institute* (June 2018).

9 *See* Ries, "First Look at the Tax Cuts and Jobs Act: Impact on Donor Advised Funds," *The CPA Journal* (May 2018).

10 *See* Notice 2018-22 (May 23, 2018), where the IRS warned taxpayers on tactics to avoid property deduction caps, indicating that Treasury and IRS intend to issue proposed regulations addressing measures that would attempt to allow homeowners to declare property taxes as charitable deductions. This Notice buttresses what Treasury Secretary Steven Mnuchin said early in 2018 in referring to potential SALT workarounds involving taxpayers "donating" their payments of their real estate tax bills to charitable organizations to be set up by local government as "ridiculous." Treasury and IRS made good on that promise by issuing proposed regulations (REG-112176-18, effective August 27, 2018) that limit the benefits of state tax credits for charitable gifts.

11 For many individuals who live in Ohio (or in a state *other than* Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming, which do not impose state-level capital gains taxes), even though the federal capital gains tax rates and rules did not change as a result of the 2017 Act, aggregate capital gains tax rates rose as a result of the 2017 Act. How and why? Starting in 2018, many such individuals will *not* be able to deduct their state capital gains taxes on their federal income tax returns, either because (i) they are already over their $10,000/$5,000 SALT deduction limitation without considering state capital gains taxes, or (ii) they are not eligible to itemize deductions and thus are taking the standard deduction.

12 P. L. 109-208, 3/23/06.

13 P. L. 114-113, 12/18/15.

14 I.R.C. § 408(d)(8).

15 Contrast the IRA charitable rollover approach with the less tax advantaged approach whereby taxpayers would (a) take their RMD into their own personal coffers, (b) dutifully recognize the resulting taxable income on their income tax returns, (c) make a charitable contribution with the cash they received from the RMD, and (d) then, assuming they are eligible to do so, take a charitable contribution itemized deduction on the same tax returns.

16 I.R.C. §§ 170(b)(1)(A), 170(b)(1)(B), and 170(e)(1).

17 What if the donor's chosen charity does not accept gifts of appreciated property and/or the donor has not yet chosen the charity or charities to receive the gift? In either or both of these cases, the donor could instead donate the appreciated property to a donor advised fund ("DAF") or a private foundation, which DAF or foundation would then sell the property and give the cash to the charitable organization(s) later identified by the donor. As a tax-exempt entity, the DAF or foundation would avoid the capital gains tax that the taxpayer would have otherwise owed following his or her individual sale of the property.

18 Note that a Charitable Gift Annuity ("CGA") could also be used in this case. Senior donors who have substantial liquid assets, including IRAs or other retirement accounts that provide substantial current income, often desire to reduce their taxable income. These donors may set up a series of CGAs by simply transferring assets directly to the charity of their choice in exchange for a lifetime annuity. The charitable gift annuity produces a charitable income tax deduction that could be used to offset the tax on annual IRA withdrawals. Another tax advantage results from the annuity taxation rules under IRC Section 72, under which a large percentage of the annuity payout may be income tax-free.

19 I.R.C. § 170(f)(8).

20 *See, e.g., Barnes v. Comm.*, T.C. Memo 2016-12 (travel for church not adequately documented); *Oatman v. Comm.*, T.C. Memo 2017-17 (no contemporaneous written acknowledgment); *Luczaj v. Associates et. al. v. Comm.*, T.C. Memo 2017-42 (no records or contemporaneous written acknowledgment); *Ohde v. Comm.*, T.C. Memo 2017-132 (no substantiation of gift of 20,000 items

to Goodwill Industries, Inc.); *Izen, Jr. v. Comm*., 148 T.C. No. 5 (2017) (failure to comply with requirement to obtain special written contemporaneous acknowledgement for gift of automobile); *RERI Holdings I, LLC v. Comm*., 149 T.C. No. 1 (2017) (denial of deduction on account of failure to provide basis information on gift of LLC interest, even though basis information was irrelevant to value of gift); and *Farolan v. Comm.*, T.C. Summ. Op. 2018-28 (May 30, 2018) (no charitable contribution deduction for cash contributions to taxpayer's church where taxpayer could not provide any bank record or any other written records of the contributions).

21 I.R.C. § 642(c).

22 *Id.*

23 *Green,* 121 AFTR2d 2018-427 (CA-10, 2018).

24 *See* Hecht, "The Golden Age of Philanthropy," https://ejewishphilanthropy.com/the-golden-age-of-philanthropy/.

25 *Id.*

End of Document © 2018 Thomson Reuters. No claim to original U.S. Government Works.