CHAPTER 1

Estate Planning and Charitable Giving

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I will continue to distribute blankets, sleeping bags, warm clothing, and food on a regular basis, in the hope that my modest efforts will give some comfort to those people we are able to help.

—Mohamed Al-Fayed, philanthropist, businessman

Em was nodding his head—he knew his client and understood exactly where this was going and he liked the big picture very much. To start things off, Em developed a detailed report including the reasons—why, from an estate planning perspective, someone would look at charitable giving as an instrumental part of their estate plan.

Starting from the beginning—estate planning is the process by which an individual sets up his or her (or in case of a married couple, their) estate (what remains after they are deceased). In the United States, taxpayers may be subject to an "estate tax" on the value of their assets upon their death—it is the minimization of these taxes that is often the initial reason why someone embarks upon charitable giving (of course, the person also has to have an interest—a "calling"—to give back to society).

Although charitable giving is not solely a U.S. phenomenon, its magnitude is to such an extent that it very well could be. Case in point, private giving in America is in excess of 2 percent of GDP—the highest of any nation, with the United Kingdom number two at 0.7 percent of its GDP. From a scope perspective it is also huge. The

IRS has certified 1.5 million organizations as satisfying the requirements for tax exempt status under sections 501(c)(3) and 501(c)(4) of the federal tax code (which define charitable and mutual benefit organizations, respectively), as well as another 353,000 religious organizations—churches, mosques, synagogues—which are not required to seek IRS certification for tax exempt status.[1] Of course, what is not listed here are the multitude of organizations that are not "institutionalized" or formatted under said standards—just simple groups of people doing good work in helping others and their communities. So why are Americans so infatuated with giving?

The answer to that question might stem from the early history of Colonial America, where religious oppression and lack of freedom persuaded these early colonialists to brave the rough waters of the Atlantic for the new world. This spirit of freedom laid the framework for the institutions that the colonialists established here in the United States. Their first order of business once on these free shores was to establish self-governing religious congregations, which provided schooling as well as worship and other services without any governmental body as an overseer. It was this penchant for independence that led to the formation of other organizations—again without the support or interference of some government body—which in turn led to the affinity groups (be it religious, racial, ethnicity, etc.) that now take on the label of nonprofit organizations.

These efforts in philanthropy took on a whole new vigor once the tax laws made it such that donations were not only a good thing to do (and often a mandated thing to do within a given group, like the tithing requirements of the Protestant religions) but also a tax-advantaged thing to do.

Going back to the early part of the twentieth century, 1917 to be exact, the IRS established rules with respect to allowing deductions of gifts to charitable or nonprofit organizations. These gifts may be cash, financial assets (stocks, securities), as well as real property, artwork, or clothing—although the deductibility of nonfinancial assets differ from those of cash and financial assets. Gifts of cash and other noncapital gain assets (those assets that cannot appreciate while holding) are only deductible up to 50 percent of the donor's

[1]Joel Fleishman, *The Foundation: A Great American Secret* (New York: PublicAffairs/Perseus Books, 2007), 15.

adjusted gross income (AGI) whereas capital gain assets (i.e., real property, artwork, financial assets) are limited to 30 percent of AGI (the reason, in part, for this is a capital gain asset has already enjoyed the "deduction" from the perspective that the donation avoids the capital gain tax as well as the deduction).

Going back to 1917, the federal government, worried that increased tax rates would dissuade private charity, introduced the deduction to gifts to nonprofits and charities. To minimize the loss of tax revenues, the government limited deductions to 15 percent of taxable income on individual returns (corporations were first permitted to make tax-deductible contributions in 1935). Part of the thinking at the time had to do with the need to subsidize the programs of nonprofit organizations and to essentially minimize the onus of these programs on the federal government. In essence, the federal government "leaned" on the goodness of the American people and their long-standing commitment to community and charity by providing them a tax incentive to continue to give and support these important organizations, and in turn, their services to those most in need. For the most part, these incentives for charitable giving, legislated by the federal government through the tax system, have remained fairly consistent—except during the Reagan administration, when a cut in federal spending for many programs led to tax deductibility of charitable gifts even for those taxpayers who didn't itemize their deductions (1981–1986).

But it might have been more than a simple "passing the buck" exercise—evidence suggests that private charitable giving is superior to direct government support.[2] By providing a tax deduction and essentially promoting charitable giving without having to do it itself, the federal government avoids potential conflicts of interest that could arise when a religious organization provides food and shelter to the poor (separation of church and state). There is also the belief, shared by many, that the government may not be as efficient or effective in its giving as a privately run charitable organization would be—especially if this organization is "competing" against other organizations for contributions.

[2] William C. Randolph, "Charitable Deductions." In *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (Washington, DC: Urban Institute, 1999).

There are many reasons why the government supports this initiative of private giving through tax deductions. Clearly, stronger efforts in education and religion can go a long way toward a stronger, safer, more civically responsible society. Education in scientific research can reduce the incidence of disease and result in higher standards of living for the society on the whole. Bottom line—the tax deductibility of gifts to nonprofit organizations has helped continue to foster the importance of charitable giving in the U.S. psyche.

Estate Planning 101

During a lifetime, people accumulate assets—from intangibles like investments (stocks, bonds, etc.) and cash balances (in all accounts—like checking, CDs) to tangible assets like artwork, jewelry, and operating businesses. These assets comprise one's estate upon death. There is a fairly in-depth process that occurs when someone dies, where an inventory of the assets is developed and an understanding of where those assets are to go now that the owner is no longer alive. For assets where there is a direct path to new ownership—a Joint Account with Rights of Survivorship, an account designated as Transfer on Death, an annuity or retirement account, where there is a beneficiary designation form already executed by the now deceased former owner, there is a clear glide-path to the destination of those assets. All other assets, be it your favorite necklace or a 1967 Chevy, need to be probated (which is from the Latin term meaning to "prove").

The Probate Process

The probate process uses the decedent's last will and testament to prove where these assets should go now that the owner has passed away. Of course, like any legal process, probate takes time (it could be years if there are litigation issues to contend with) and can be costly (although there are statutory guidelines, which vary by state). Other expenses, again governed by statutes, are the commissions paid to an executor or executrix who handles the entire estate process.

Once the will is admitted to probate and the executor (or executrix) is given the Letters Testamentary from the Surrogate Court, the probate process begins. The executor is charged with the responsibility to marshal all of the decedent's assets, pay all creditors

and manage the affairs of the estate in a fiduciary conscious fashion. A detailed accounting of all activities—both from a balance sheet (assets and liabilities) as well as an income statement (income and expenses) perspective is compiled. Next step? Taxes.

An estate tax is a tax on the fair market value of the decedent's assets on the date of death (or actually, the executor has a choice of using the date of death valuation or the entire estate's valuation six months from the date of death). Typically, the executor will choose the lower valuation in order to mitigate any taxes on the estate; however, in doing so, the decedent's income tax return might be impacted (because the value of an asset on the estate's tax return becomes the new basis for the asset for income tax purposes). Understanding these somewhat complex issues is tantamount to the responsibilities of the executor and therefore it is advised that the executor seek professional counsel (an attorney specializing in trust and estate law) when embarking on such decisions. These somewhat complex legal matters, like many things in life (from the important, like investment management to the mundane, like haircutting) are best not to do alone but alongside professional counsel; making a mistake can be life-altering, or in the least, embarrassing.

The estate tax return is due within nine months from the date of death and it can have tax rates as high as 35 percent of the assets in the estate (because of this somewhat quick time frame families are often forced to sell assets quickly to pay the estate taxes, which is where the term "estate sale" originates). Which assets are included in this taxable asset inventory? Well, most are (yes, including that necklace and old Chevy!) with the exception of assets in specially designed trusts (irrevocable trusts). It is important to note that assets that pass to a surviving spouse are not taxed and there is no limitation to the amount that can be passed, estate tax free, in this manner, but, of course, when the surviving spouse passes all of the assets in her name (unless she remarries) will be estate taxable (hence the insurance policy known as "second to die," which is triggered when the surviving spouse dies and the taxes are then due).

In calculating the estate tax, the IRS provides a coupon for a certain amount of assets in the decedent's estate that are not taxed—this is called the *unified credit* (with the Bush-era tax cuts being extended for two years, the unified credit amount was increased to $5 million per person) and only assets above this amount are taxable

in the estate. Please note that in the above we are discussing federal estate taxes—there is also, in most states, a state estate tax with substantially lower unified credit levels and tax rates.

Besides irrevocable trusts (trusts that can't be changed or terminated in contrast with revocable trusts), which "shelter" assets from estate taxes (because assets in these trusts are typically considered "outside a decedent's estate" and therefore are not estate taxable), the other tool for reducing one's taxable estate is the concept of gifting away assets. Anyone may give assets to anyone else—and these gifts are, up to an annual limitation per person, not taxable as gifts (gift tax exemption) and are not counted as assets in the grantor's estate. The gift tax limit, as of this writing, is $13,000 annually—gifts above that amount to any one person is taxable as a gift (gift tax rates are in the 35 percent range). A grantor can avoid this gift tax by reducing his or her unified credit amount—but that will have implications when it comes to estate tax minimization as well. Of course, without this gift tax construct, anyone would simply gift all of their assets to his or her family and die with a smaller estate and avoid the estate tax.

In addition to the $13,000 per person ($26,000 for a married couple) per year that someone can give to anyone else and have it exempt from gift taxes and reduce one's taxable estate, are donations made to public or private (foundations) charities. A public charity is a 501(c)(3) exempt organization, while a private foundation is typically governed by section 509(c)(3). Grantors in these cases do have limitations from a tax deductibility perspective—they can deduct on their personal income taxes a donation up to 50 percent of adjusted gross income (AGI)—and an additional amount can be carried over, and utilized as deductions, for five years. With respect to private foundations the bar is set at 30 percent of AGI—again with a carry forward provision. Once individuals max out their contributions to a private foundation, typically they can still make a tax deductible contribution to public charities. Other types of assets—real estate, artwork, and so on—can be donated to a foundation, but are subject to limitations.

In the estate planning process, professionals counsel clients seeking to reduce the value of their taxable estate to enter into a yearly gifting program to those individuals to whom they want to pass their capital, as well as to make donations to charity. In each case the taxable estate is reduced and, all other things being equal,

that would mean a lower estate tax bill. Estate planning is made infinitely more difficult, from an estate tax minimization goal, once the person passes. Upon death the individual is no longer an entity (although they will have to file a personal income tax return for the period between the beginning of the year and their date of death) and the "estate of the decedent" begins. So, the gifting exercise ceases to be useful as a means by which one can reduce the value of the estate (you can't give a gift if you no longer exist).

The Anthonys were somewhat well-versed in this area—they had sought the counsel some years ago of an estate planning specialist—an attorney who was actually recommended by Emmett. It was this attorney, together with Emmett, who suggested the long-term care policies that Phil and Mary purchased several years ago, as well as the Irrevocable Life Insurance Trusts (ILITs) that house their life insurance policies (using an irrevocable trust removes the asset from their taxable estate and allows the proceeds to pass down to the kids in a trust set up for their use). "I am pleased to learn that we have executed the initial phase of our estate plan in an effective format," said Phil.

But what about the bequests made in one's will? The bequests (gifts written into the will and only come into play once the will is probated) are income tax-free to the recipient and, for the most part, are not deductible on the estates' income tax return. Nor do these postdeath gifts (the definition of a bequest) reduce the value of one's estate. But what are fully deductible on the estate tax return (in other words, what we can use to reduce the value of one's taxable estate) are donations made in a will to a public charity. They may also be partially, up to an AGI limit, tax deductible on the estates' income tax return.

Gifting Techniques and More Advanced Estate Planning

There are advanced gifting techniques that are beyond the scope of this work—establishing trusts like GRATs and GRUTs, where the donor provides a gift today for future return of either a terminal value or cash flow, and in doing so is able to discount the value of that gift for estate tax purposes. Why? Because the value of a future gift is less than the value of a current gift and therefore the IRS permits discounting (the reduction of value due to a stated interest rate and time) when calculating the value of that gift for estate tax

purposes. There are also family limited partnerships (FLPs), which are set up to "house" business interests where the donor is a general partner and therefore is able to discount these assets because he or she no longer owns 100 percent of the asset. The vehicle known as a Qualified Personal Residence Trust (QPRT) works in a similar fashion—discounting the value of a residence or real property for estate purposes because it is being gifted to a trust. This trust is held usually for the benefit of the grantor's children. "This could be an excellent tool to keep Sandy Haven in the family," said Mary excitedly. Em agreed.

There are also more everyday techniques that permit reductions to one's taxable estate. The IRS permits prepaid funeral expenses as deductible from one's estate for tax purposes. Also, qualified educational expenses are exempt from gift taxes and therefore can be paid (reduction of assets) without incurring gift taxes. There is also the concept of "accelerated gifting," with college 529 plans being the most common of these programs. Gifts to these plans—which allow for tax-free growth if the invested capital is used for secondary educational expenses—can be accelerated by five years without incurring the typical gift tax liabilities. For example, if Grandpa and Grandma Jones are seeking to reduce their taxable estate and are contemplating a $26,000 gift ($13,000 per person) to each of their five grandchildren, essentially removing $129,000 from their taxable estate, they could make that gift of $129,000 per grandchild today (removing $645,000 from their taxable estate). That capital gets invested today and begins to compound tax-free in the 529 plan (outside their estate but still controllable by them), which can make a big difference in the terminal value years in the future. There is a catch, however; the IRS requires that the donor in this advanced gifting program live for the five years after the gift is made in order to remove the entire gift from his or her taxable estate.

Phil and Mary both saw the light immediately with using 529 plans to establish their multigenerational educational legacy—"this would be a perfect way to insure that our grandkids and even their kids would have a means towards higher education," said Phil. "As the rules are written today, 529 plans enjoy tax-free growth if used for higher education expenses, and the value of this account would be outside of your estate but you can control the disposition of the assets—truly a win-win," said Em. "In addition," Em continued,

"the beneficiaries of a 529 plan are fungible, which means that if one grandchild receives a full scholarship to a school of his or her choice and therefore does not require the capital from the 529—the beneficiary can be changed to another grandchild who might need greater assistance for say graduate school." The issue of ensuring a multigenerational legacy can be achieved through naming successor trustees to each 529 to handle the next generation after Phil and Mary are no longer around.

When all of these techniques, both the easy and the advanced, are maxed out, the estate's remaining value is assessed upon death and the tax is levied as described. The estate tax return is compiled, which lists all of the assets that comprise the taxable estate, and the resulting tax is calculated.

Responsibilities of an Executor

The executor (or executrix) is the person who has been chosen by the decedent, and specified in his or her will, as an "agent"—to carry out the wishes after his or her death. The executor administers the estate and has a wide spectrum of responsibilities and powers as detailed below:

Immediate Actions

You learn that someone close to you (a family member, a friend, a client) has passed away. You believe that you were designated as his executor (of course, there can always be the case that the will was changed and a new executor was named)—so what do you do now? First things first, you need to—together with the family—arrange for the decedent's funeral and burial. The person who is arranging this may only be the "nominated executor," which means that the court has not yet accepted the will for probate (on doing so, the designated executor named in the will receives Letters Testamentary, granting him or her the powers and responsibilities of managing the estate).

Probate

The will is filed with the Surrogate Court and the estate process begins. Once accepted, the court issues Letters Testamentary to the executor granting him the powers over the estate and its assets. The responsibilities of the executor are wide ranging—from marshaling assets and disposing of debts to adhering to the wishes of the decedent via the will as to bequests and the residuary assets (what's left after the bequests). Which assets does the executor handle?

(*Continued*)

For the most part it is all of the assets but it is important to denote the differences between the gross estate and the probate estate's assets—the differences are the assets that pass by operation of law—that is, those assets held in joint accounts or transfer on death accounts or those with a beneficiary agreement (IRAs, annuities, life insurance policies). These assets are not under the control of the executor or the estate, for they automatically pass to the designated party through an operation of law upon death.

Sixty Days from Date of Death

In the first 60 days, the executor must transfer all of the decedent's probate assets (those that did not pass by operation of law) in the name of the estate (typical titling: "The Estate of Robert Jones") and under the control of the executor. The executor then must ascertain the liquidity needs of the estate—the bequests in the will, creditors to be satisfied, and any expenses and taxes, and to that end perhaps sell assets to raise the cash needed. With respect to taxes, there are three returns that the executor will potentially need to sign off on: the personal income tax return (from start of year to date of death), the estate income tax return (may be required if the estate generates substantial income, and is due within 3½ months after the close of the estate's taxable year), and the estate tax return. There will probably be a federal set of these returns as well as a state set.

Within Six Months from Date of Death

The executor needs to make a decision on what valuation date he is using for the estate's assets—the date of death or the value six months from the date of death. As discussed, this decision can have consequences for the other tax returns and therefore should not be taken lightly.

Within Nine Months from Date of Death

The estate tax return is due as well as any tax liabilities. Also, the estate must file an inventory of assets in the estate with the probate court. Finally, in order to obtain the court's approval on the completion of the administration of the estate the executor will need to file a complete and formal accounting with the probate court. It is only after this accounting is approved can the executor be compensated—receive his commission, which is based on statutory calculations and vary from state to state. In New York, for example, an executor's commission is fixed by law. The applicable law is New York Surrogate's Court Procedure Act, Section 2307. Commissions are based on the size of the estate and are computed as follows: (1) 5 percent of the first $100,000; (2) 4 percent of the next $200,000; (3) 3 percent of the next $700,000; (4) 2.5 percent for the next $4,000,000; and (5) 2 percent for amounts exceeding $5,000,000.

The Estate Planning Process

"Okay, so what does this have to do with charitable giving?" Em can hear Phil asking himself when he reads this report. Well, the report continues, any donations, gifts, or transfers to qualified charitable organizations are estate tax deductible. (See Exhibit 1.1 for

Exhibit 1.1 Gifting Scenarios in Estate Planning

	Scenario	Personal Income Tax Return	Estate Income Tax Return	Estate Tax Return
During Lifetime	Person gives gift to someone else	Not deductible and if above Gift Tax exemption amount could be subjected to gift taxes	Not Applicable	Not Applicable
During Lifetime	Person gives donation (cash) to public charity (including a Donor Advised Fund)	Deductible up to 50% of Adjusted Gross Income (AGI) with a 5-year carryforward	Not Applicable	Not Applicable
During Lifetime	Person gives donation (securities) to public charity (including a Donor Advised Fund)	Deductible up to 30% of Adjusted Gross Income (AGI) with a 5-year carryforward	Not Applicable	Not Applicable
During Lifetime	Person gives a donation (cash) to a private foundation	Deductible up to 30% of Adjusted Gross Income (AGI) with a 5-year carryforward	Not Applicable	Not Applicable
During Lifetime	Person gives a donation (securities) to a private foundation	Deductible up to 20% of Adjusted Gross Income (AGI) with a 5-year carryforward	Not Applicable	Not Applicable
After Death	Decedent gives gift to someone else in their will (a bequest)	Not Applicable	Not Deductible	Not Deductible
After Death	Decedent gives gift to a public charity in his will	Not Applicable	Possibly fully deductible–depends upon the proportion left as a residuary clause in the will	Fully Deductible–no restrictions
After Death	Decedent gives gift to a private foundation in his will	Not Applicable	Possibly fully deductible–depends upon the proportion left as a residuary clause in the will	Fully Deductible–no restrictions

an overview of the various scenarios.) That means that it reduces your estate, which has the ultimate outcome of fewer assets and less taxes. So those individuals or families that are particularly charitably minded can receive a benefit—a tax benefit in death or while alive—by making donations to their favorite charities. The donations reduce the taxable estate and therefore the tax levied against the estate. "All well and good," Phil would say, "but our interests are more aligned on the charitable side—the actual giving—than the saving on taxes, although that does seem to be a nice additional benefit." Emmett knew his clients were more interested in setting up a plan to provide their children and grandchildren and even great-grandchildren with a duty or legacy for charitable mindfulness rather than schemes to reduce taxes on their estate—although the concept of maintaining more assets (paying less taxes) for these charitable efforts would not be lost on them.

Case Study—Estate Planning 101

Fact Pattern:

- Mr. and Mrs. Robert Jones, married for 55 years, 4 adult children, 10 grandchildren.
- Sold private business two years ago—net worth is greater than $16 million, $11 million of which is liquid investments.
- Considering changing their current basic "I Love You" will, which leaves all of their assets to each other and then to the children in order to reduce the likely estate taxes on their passing.
- Advocates of the importance of education for their children and grandchildren.
- Charitably minded—Juvenile Diabetes Research Foundation has been a favorite charity for many years (since their youngest was diagnosed at 15 years old).
- Objectives: A simple plan (nothing too complex) that reduces or at least minimizes the estate tax burden for the next generation, to augment charitable giving, and to provide heirs with a good education and about $10 million in assets (in total).

There are many ways to go here—from the elegant and complex estate plan to a simpler plan that might accomplish the same goals. (See Exhibit 1.2 for a simple flow chart of the various paths available.) Given the Joneses' interest in "keeping it simple" the following solutions are offered:

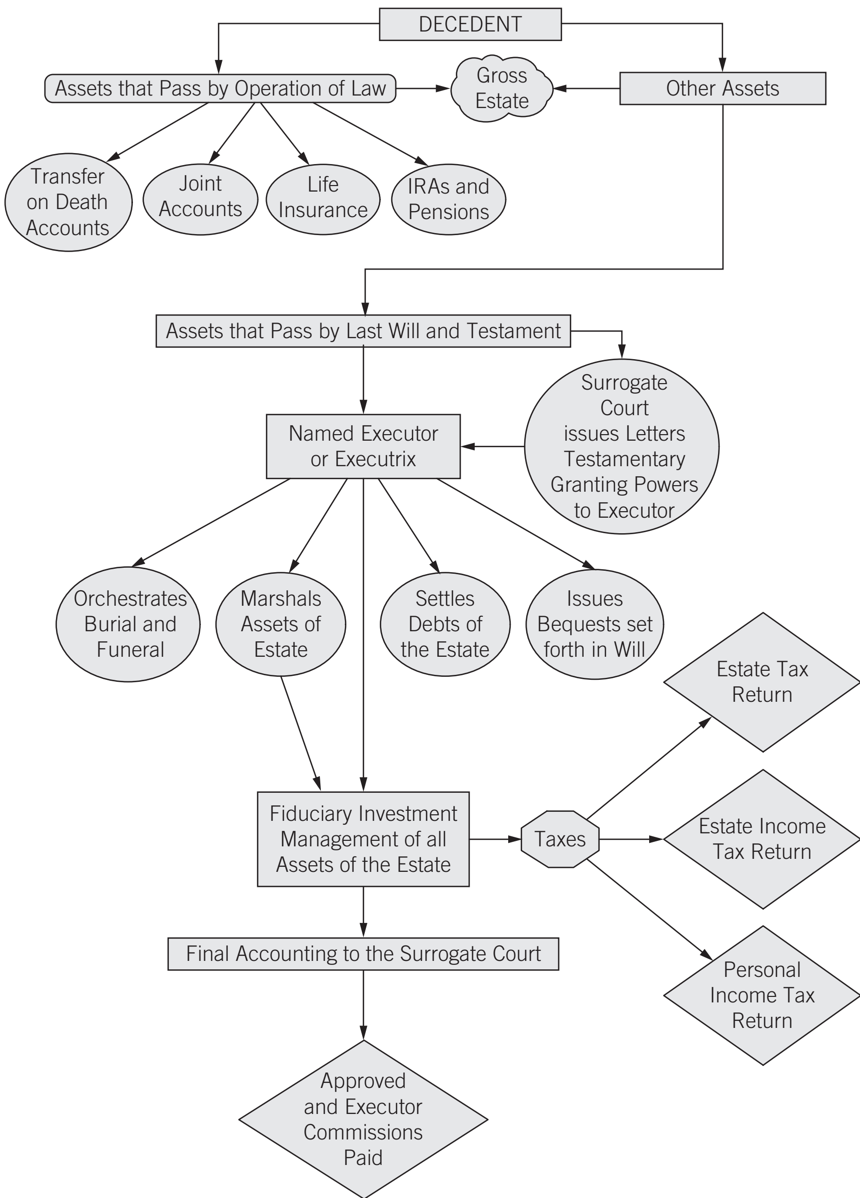

Exhibit 1.2 The Estate Flowchart

- Retitle assets so that each has at least $5 million of assets in their name. These accounts, again keeping it simple, can be designated as Transfer of Death (TOD) accounts for each of their children (this is a simple, cost-effective way to move assets from one party to another). These assets will be

included in their estate, but due to the exemption will not be taxed (although the issue of the next generation's assets and their eventual estate tax is why one should consider a more detailed estate plan with trusts that can shelter assets from estate taxes).

- Maintain the remaining assets in a Joint with Rights of Survivorship account. Enter into an annual gifting program to each child and spouse (and possibly to other relatives or friends)—providing the maximum gift each year, which is gift tax exempt and reduces (or maintains, depending on the growth of the estate) the value of the estate.
- Make 529 contributions—five years' worth ($26,000 per grandchild times five years, times 10 grandkids equals $1,290,000 of assets out of their estate, assuming they live the five years). These assets remain fully controlled by Mr. and Mrs. Jones and are designated for each grandchild's education.
- Pay any educational expenses as they arise, which reduces the estate further—without any gift tax exemptions.
- Make charitable donations to Juvenile Diabetes Research Foundation (other charities) up to the maximum of 50 percent of AGI each year. These will be fully tax deductible on the income tax returns and will also reduce the value of the taxable estate.
- In the will, designate probate assets (that is the amounts above the TOD accounts and the joint account) to go to charity of the Joneses' choice. This bequest is fully tax-deductible to their estate's tax return.

Summary

In this chapter we learned the basics of estate planning with an emphasis placed on the gifting aspects in the estate planning process. Gifting has its immediate tax benefits to one's estate, but there are also the considerations of control and the level of flexibility a donor expects in his or her gifting program. In the next chapter we dive further into this gifting issue with a deeper examination of charitable giving—the vehicles available to achieve one's stated charitable gifting goals.