The Tax Aspects of Giving

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FOR: NORTHERN CALIFORNIA PLANNED GIVING COUNCIL

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Goals for Today's Presentation:

- Goal #1: If you are not a tax expert, we do NOT want you to become one. We DO want you to be able to "talk tax" a little bit easier and make the tax aspects of giving less intimidating.
- Goal #2: If you ARE a tax expert, we are NOT going to try to teach you anything new. Hopefully, you get something out of going "back to basics" and thinking about familiar tax topics in a different way.

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Ideas to Cover

1. Why do we have to talk about taxes? We're tax-exempt!
   - A. Donor Motivations
   - B. Exempt Doesn't Really Mean Exempt
2. Basic Concepts From a Donor Perspective:
   - A. The Two Basic Types of Income: Ordinary Income and Capital Gain
   - B. Key Concept of Capital Gain #1: Realization
   - C. Assignment of Income – When You Can Avoid It; When You Can't
   - D. Key Concept of Capital Gain #2: Basis – What it is, how it changes, how it transfers
3. Going one level up:
   - A. The Value and Limits of an Income Tax Deduction
   - B. The Value of Tax Deferral and Tax-Favored Income Streams
   - C. Putting It All Together: How Do These Concepts Play Out in Your Typical Planned Gift

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Why Do We Have to Talk About Taxes?

Reason 1: Well….why do people make planned gifts?

TOP 4 ECONOMIC REASONS THAT PEOPLE MAKE CHARITABLE GIFTS, INCLUDING PLANNED GIFTS (…not counting "doing good")

1. Avoid (or for CGA/CRUT, Defer) Income Tax on Appreciated Assets
2. Income Tax Deduction
3. Tax-Favored Income Stream for a Term or Life (e.g. CGAs and CRTs)
4. Avoid Estate Taxation/ Removing Asset From Taxable Estate

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Why Do We Have to Talk About Taxes?

Reason 2: Charities Have to Pay Them Too…Sometimes

The Relationship Between Charities and Taxes

We are a 501(c)(3), so we don't pay income taxes…

Unless the income is from unrelated businesses…

But it's OK if it's passive income

Rent

Gains

Royalties

Dividends

Interest

Except when it's not OK…

Debt-financed income

From Controlled Entities

S-Corps

Operating Partnerships

We are trying to avoid unrelated business income tax rules today, but the bottom line: charities need to understand taxes too

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Types of Income:

Our tax system has almost always treated these two types of income very differently – typically capital gain rates are significantly lower.

ORDINARY INCOME

Donor does work: salary is ordinary income

Donor lends money: interest is ordinary income

Donor owns corporate shares: dividends are ordinary income

Donor leases land: rent is ordinary income

Donor licenses intellectual property: royalty is ordinary income

Donor sells "inventory": profits are ordinary income

CAPITAL GAIN

Donor sells investment property (i.e. a capital asset), Donor pays tax on the "capital gain".

Property Held for Investment (real estate, cryptocurrency, stock in company, artwork, etc.)

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"Fun" Fact #1: the same property can generate two different kinds of income depending on how it happens.

"When I rent this to a tenant, the rent is "ordinary income".

"When I sell this house to another buyer, my profit is "capital gain".

Why? Because assets held for investment are "capital assets" and when you sell them, it's a capital gain.

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"Fun" Fact #2: Some types of property still generate ordinary income, even after you sell them

For some reason we call these "Hot Assets". A couple examples:

Inventory

Receivables

You might see this come up if someone wants to donate a business or the assets of a business – these kind of assets have special rules sometimes.

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Back to the Main Point: Capital Gain

Most of what is donated to you are “capital assets” or “assets held for investment” and the biggest driver of charitable giving is avoiding “capital gain”, so let’s unpack what that is:

Q: How would a normal person define a gain on a sale?

A: Something like: “It’s how much I sold it for minus how I bought it for…”

Q: How does Congress/the IRS define a gain on a sale?

“AMOUNT REALIZED” — “BASIS” = “GAIN”

This one’s easy: the cash and the value of any other property you get in the sale*

*Including relief of debt

This one’s harder…

But it comes up a lot when we’re talking about giving.

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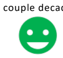
What to Realize About Realization

The “amount” realized is easy enough. But don’t skip over a fundamental feature of our tax system: the “realization requirement”. We don’t have a ‘mark to market’ system.

Hypothetical lawyer collects $1,000 for services

Hypothetical lawyer pays ~$350 in taxes

Hypothetical founder’s stock in company goes from $150M to $100B in value over a couple decades



Hypothetical founder pays ~$0 in taxes if they don’t sell

WHY? No “Realization”. When founder sells, they pay tax. If they don’t sell*, they don’t pay tax on the increase in wealth

THIS is what drives a LOT of charitable giving: avoiding the consequences of “realization”

*“Fun fact #3” – borrowing on the value of stock does not count as selling!

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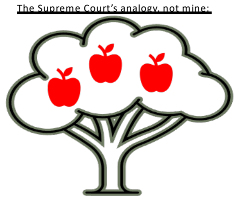
QUICK DETOUR: Assignment of Income

The Assignment of Income Doctrine: if you’re about to recognize income, you can’t just ‘assign’ the income from your property to someone else (including a charity), you pay the tax if you own the thing that creates the income.

To get the desired tax result, the Donor needs to:
- Give the tree (the thing that creates the income),
- NOT the fruit by itself (just the benefit of owning the tree)

AND it needs to do that BEFORE the “Realization” event

<u>The Supreme Court’s analogy, not mine:</u>



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QUICK DETOUR: Assignment of Income

Q: Can I assign my salary to a charity so I don’t have to pay taxes on it?
A: No, because the “tree” is your labor and you can’t give that to a charity.
(You can give the cash, but you’re still reporting the income, *maybe* offset by a deduction)

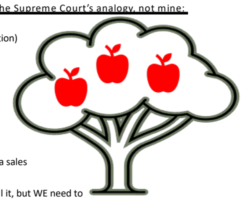
Q: Can I assign the rents I collect from my tenants so I don’t have to pay taxes on it?
A: No, because the “tree” is the property and you still own that in this scenario
(You can give the cash, but you’re still reporting the income, *maybe* offset by a deduction)

Q: Fine, can I give you the property so YOU can collect the rent?
A: Yes! That works – you will get a deduction for the property and the rent shows up on our (tax-free!...usually….) return

Q: Good news – you don’t even have to worry about collecting rent. I’ve actually got a sales contract in place to sell the thing. So I can give this to you, and avoid the gain, right?

A: Sorry but no. Now, you’re giving us the fruit again (the sales proceeds). We can sell it, but WE need to be the ones to sell it. We need to get this property at a time when we still have a choice. Otherwise, the “assignment of income” doctrine applies and YOU pay the tax on the gain.

<u>The Supreme Court’s analogy, not mine:</u>



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The Basics of Basis

Every asset you own has a magic number called its "basis" (aka its "tax basis" or its "cost basis")

It starts out easy:

$1,000,000

My owner bought me for $1,000,000, so that's my basis

But basis is a moving target…

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The Basics of Basis

Starting point: $1,000,000

$1,200,000 — My owner sold me for $1,200,000, so now that's my basis for the new owner

$800,000 — My owner used me for business and took $200k of depreciation deductions on their tax return, so now this is my new basis

$1,050,000 — My owner spent $50,000 to improve me so now this is my new basis

$2,000,000 — My owner died when I was worth $2,000,000 on the market, so that's my new basis.

Remember: the higher the basis, the lower the gain

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What was the point of all that?

1. Charities pay taxes too sometimes, and you need to think about that when you accept certain types of gifts
2. The difference between ordinary income and capital gain is important
3. Realization and giving before realization is fundamental to charitable giving
4. Basis is more complicated than just "how much did you pay for it"
5. Some of your favorite planned giving strategies rely on all of these concepts

Any questions before we keep going?

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A Hypothetical

- I bought this rental property for $100k. I took depreciation deductions of $50k. It's now worth $750k and I am not using it anymore.
- I want to make a meaningful gift to charity.
- I am still working and a have about $200k per year in income
- I'm 45 years old and am starting to think about retirement

Charity

$50,000

<u>What are the Tax Benefits of Giving That Charity Can Offer Here?</u>

1. Avoid or Defer the $700k of Capital Gain ($750k – the new basis of $50k)
2. Charitable Contribution Deduction to Reduce Tax on Salary
3. Tax-Favored Income Stream for Retirement
4. Remove from Taxable Estate (???)

We have talked about how avoiding gain, let's start talking about the deduction…

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What is the Amount of the Deduction?

Let's start with a "simple" question, what is the amount of the deduction on this gift?

~~A. $50,000~~
~~B. $750,000~~
~~C. Some other number~~
D. It Depends!!

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What is the Amount of the Deduction?

It is WAY too complicated to cover in a basics section, but the amount of the deduction is determined by 4 things – can we guess them all?

- The type of asset
- The holding period
- The type of recipient
- For certain assets (e.g. artwork, intellectual property, vehicles), what the charity does with it.

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Determining the Amount of the Deduction

Recipient	Cash	Publicly Traded Stock (Held > 1 year)	Capital Gain Assets (Held > 1 year)	Capital Gain Assets Held for < 1 year and "Hot Assets"	Tangible Personal Property (e.g. works of art)	Intellectual Property (copyright, patent, trademark).
Public Charity, DAF, or POF	$$$	Fair Market Value	Fair Market Value	Basis, though special rules for certain inventory*	Basis, UNLESS there is a related use*, in which case FMV (also special rules for vehicles)	Basis (BUT special rule*: additional deduction in later years for income on IP)
Private Foundation	$$$	Fair Market Value	Basis	Basis	Basis	Basis (BUT special rule*: additional deduction in later years for income on IP)

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What's the *Value* of the Deduction?

So, in our example:

Basis: $50K
FMV: $750k

Let's assume that it's a full fair market value deduction of $750k.

That means that (subject to a bunch of rules), the deduction could "cancel out" $750,000 of income. How do we value this benefit to this donor?

The economics answer:

AMOUNT OF THE DEDUCTION	×	TAX RATE	=	VALUE OF DEDUCTION
$750,000	×	35%.	=	**$262,500** the "value" of the donor's deduction (i.e. the amount of tax theoretically saved)

BUT: that might not actually be true for this donor, because it assumes there is enough income to use the deduction

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Can You Even Use the Deduction?

What if the donor is the hypothetical lawyer from before?

Can probably use some of it, but not enough income to use up the full $750k – so a lot of that value probably lost

What if the donor is a different, dramatically more successful hypothetical lawyer?

Then maybe!

What if the donor is the hypothetical founder from before?

If they are not selling the stock and don't have other income, then no, the deduction has no value

What if the hypothetical founder has a change of lifestyle and sells stock to start spending some money?

Then definitely!

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But It's Even More Complicated Than That…

Most deductions you get to take, regardless of much income you make. But the charitable contribution rules have special rules called AGI limits. They are complicated – this is an **oversimplified** summary:

Recipient	Cash	Publicly Traded Stock (Held > 1 year)	Capital Gain Assets (Held > 1 year)	Capital Gain Assets Held for < 1 year and "Hot Assets"	Tangible Personal Property (e.g. works of art)	Intellectual Property
Public Charity, DAF, or Private Operating Foundation	60%*	30%	30%	50%	50%, unless related use, in which case 30%	50%
Private Foundation	30%	20%	20%	30%	20%	30%

If we assume that the donor has held the property for more than a year and is donating to a public charity, we are talking about a 30% AGI Limit.

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What Does a 30% AGI Limit Even Mean?

In our hypothetical, let's assume we are talking about a $750,000 deduction and that the 30% AGI limit applies:

If our donor has $4M in Adjusted Gross Income (aka total income for the year after certain "above-the-line" deductions)…

Then…they can take up to $1.2M (30% x $4M) in this type of deduction. ***That is enough to use up the $750k in the year of the gift.***

So, they get the FULL benefit of the charitable contribution deduction

If our donor "only" has $1M in AGI, then they can only take up to $300k of this kind of charitable contribution deduction.

In this scenario, the donor ***uses $300k in the year of the gift, and has to roll the rest over (up to 5 years to use).***

So they only get PART of the benefit* of the charitable contribution deduction.

**Why only part if they eventually use it all up? See the time value of money.*

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The Time Value of Money

To keep it real simple: having money NOW > having money LATER; OR paying money LATER > paying money NOW.

Example: (a) You have $100; (b) You owe a tax of $10; (c) You have an investment account averaging 5% per year

If you pay the IRS now, you will have $90

You invest that $90 and make $4.50 from it.

One year from now, you will have $94.50

If you pay the IRS a year from now, you still have $100

You invest that $100, and make $5 from it.

One year from now, you will have $105, then pay the tax and you have….$95

That $.50 difference = the heart of a lot of tax planning and charitable planning

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How Does the Time Value of Money Work in a Charitable Gift

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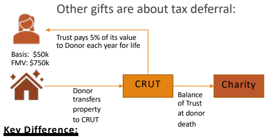
Some gifts are about tax avoidance (i.e. an outright gift of an asset about to have a "realization" event).

Other gifts are about tax deferral:



Key Difference:

- If donor sold property, $700k of gain in year 1
- The CRUT does NOT pay taxes.
- With CRUT donation, payments only taxed as received by the Donor

Even if Donor lives long enough to receive all of the $700k back in payments and to pay the tax on it, you would rather pay that tax over 30 years (or however long she lives).

Tax DEFERRED = Tax REDUCED

During that time, the tax savings on the donated asset can be used to grow the Trust, and grow the payments to donor

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Same Basic Idea with a Charitable Gift Annuity

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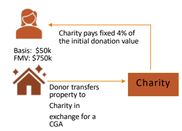

- This is treated as a "bargain sale" (i.e. ~$275k of this is charitable contribution and the rest of it is an installment sale).
- With installment sales, the donor recognizes the income over time, instead of all at the beginning. Tax DEFERRED = Tax REDUCED
- Just like a CRUT, a Charity's investments grow tax-free. So they can offer greater rates than a taxable entity in same position.

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One last thing: the history of estate and gift tax in two minutes…

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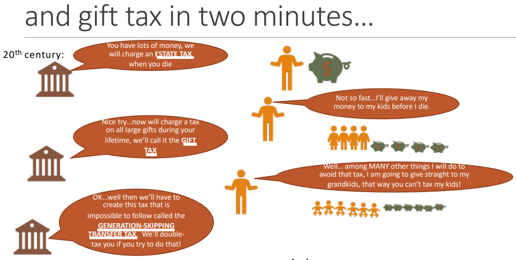
Early 20th century:



And so on…

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What matters about the Estate and Gift Tax to You

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1. Very few people need to pay it (current exemption ~$13M per person, stackable in a married couple) – so unless you have at death (or give away during life) more in assets than that, it's not going to apply to you (about 0.1% of estates pay estate tax).
2. If you do pay it, it's a big number (40%) – so donors that pay it are highly motivated to avoid it.
3. Most tried-and-true way to avoid estate/gift tax : charitable giving. UNLIMITED charitable contribution deduction from gift and estate tax for gifts to charities (public charities or foundations)
4. Be aware that some charitable gifts (e.g. split-interest gifts with a non-spouse beneficiary) can have surprising estate and gift tax consequences)
5. Some vehicles for avoiding gift/estate tax involve charities (e.g. the charitable lead trust)

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A Hypothetical

- I bought this rental property for $100k. I took depreciation deductions of $50k. It's now worth $750k and I am not using it anymore.
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- I am still working and a have about $200k per year in income
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Charity

Basis: $50,000
Fair Market Value: $750,000

Question for Audience: What are the Tax Benefits We Should Talk About Here? Are There Any Other Questions We Should Be Asking?

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Random Questions and Anecdotes?

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