Issues AND INSIGHTS

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Donor Remorse:
Common Mistakes in Charitable Giving

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Many donors not only want to do "good," but want to ensure that they also do "well" with their charitable gifts, making them as meaningful as possible to their values, as useful as possible to the charities they benefit, and as tax-efficient as possible.

Sometimes the best way to learn is through the mistakes of others. Hopefully, by being aware of some common pitfalls people make in charitable giving, you can make your gifts meaningful, useful, and tax-efficient.

Caveat: This article is based on current income, estate, and gift tax law. Congress is expected to consider tax reform during 2017, and if legislation is passed, some of the results discussed in this article may change. Philanthropic families may want to defer major gifts until later in the year when the outlook for tax change is clearer.

1. Cash is not always king

It's easy to write a check to your favorite charity, especially as it gets closer to year-end. But, a gift of long-term, appreciated publicly held stock is often a more tax-efficient gift than cash. When a donor gives publicly traded securities held for more than a year to charity, the donor is generally allowed a full fair market value deduction for the donated securities, up to 30% of adjusted gross income (AGI) if

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donated to a public charity; 20% if donated to a private foundation. And, the donor avoids the tax that would have been due on any future sale.

But remember that the stock must be held more than one year, or the deduction will be limited to basis, generally the initial purchase price. And, not all gifts of property are the same. They must be looked at asset by asset, and the charitable recipient can matter too.

If you plan to make a gift of stock or other property, be sure to allow enough time to make the transfer. Some smaller charities may even need to create a process for accepting such gifts and to establish a broker relationship. And some gifts of property will take negotiation and possibly a gift agreement.

2. An unacknowledged gift of over $250 is a non-deductible gift

It seems like a small administrative detail, but donors have lost the benefit of large charitable contribution deductions by failing to obtain an acknowledgement of their charitable gifts. For a gift of $250 or more to be deductible, the donor must obtain a "contemporaneous" written acknowledgement from the charity. This requirement is met if the donor obtains the acknowledgement by the earlier of filing the tax return or the due date for the return, including extensions. This rule is strictly enforced and deductions can be disallowed even when there is substantial compliance with the rules. Even a family foundation must acknowledge a gift made by a donor, including donors who founded the foundation or serve as its directors or trustees. Note that the acknowledgment probably will inform you if your gift must be reduced by items of more than nominal value that you received in exchange for your donation.

3. Beware of gifts of closely held and S Corporation stock

Closely Held Stock

First and foremost, don't give closely held stock to a private foundation. With very few exceptions, this can turn out to be an expensive headache. Unlike publicly traded stock, a donor's gift of closely held stock to a private foundation cannot take advantage of a full fair market value deduction. Instead, the deduction is limited to the donor's "tax basis," generally the initial purchase price of the stock. Even if a donor is willing to forgo the fair market value deduction, the "excess business holding rules" applicable to private foundations may make it difficult for the foundation to hold the stock for the long term, and the "self-dealing" rules applicable to private foundations likely will make it difficult to sell the stock to the donor's family, who are often the most likely interested purchasers.

Even if your gift of closely held stock will be to a public charity, including a donor advised fund, be prepared to work out a plan with the charity for an exit strategy. Most charities that receive such gifts of hard to value assets have policies to sell the gifted assets.

S Corporation Stock

Think twice before donating S Corporation stock. Some charitable trusts, such as charitable remainder trusts and pooled income funds, are not permitted shareholders. While a charitable lead trust is permitted to hold S Corporation stock, the trust will not be allowed to take charitable deductions for S Corporation income distributed to the charitable beneficiary.

Although S Corporation stock may be given to other charitable organizations, the earnings, including capital gains on sale, will be taxable to the charity as unrelated business taxable income. By contrast, most earnings from stock are not taxable to a charity.

Finally, if S Corporation stock is given to a private foundation, it will be subject to the deduction limitations, excess business holding rules, and self-dealing rules discussed above.

4. Don't forget your IRA assets can be left to charity

Many an heir has regretted inheriting IRA assets from a decedent whose estate left more tax-favored assets to charity. IRA assets are heavily tax-burdened and can be very attractive for gifts to charity, rather than family. If your estate will be taxable (i.e. exceeding the current $5.49 million exemption for 2017), the IRA will be

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subject to estate tax. Furthermore, the heirs of an IRA must pay income tax on the IRA distributions to them. There are no restrictions on how much of your IRA you can leave to charity at your death, and the transfer will not be subject to either income or estate tax.

By contrast, if you leave non-IRA assets to your heirs, generally the basis in those assets will be "stepped up" to fair market value at death, and the heirs will have capital gains only on future appreciation.

The IRA charitable rollover provision permits individuals aged 70 ½ or older to transfer up to $100,000 directly from an IRA to a "qualified" charity without recognizing income or taking a charitable contribution deduction. The amount transferred to charity also counts to satisfy all or part of the required minimum distribution. The IRA charitable rollover provision was made permanent by the Protecting Americans from Tax Hikes (PATH) Act of 2015, which was signed into law on December 18, 2015. The IRA charitable rollover can be very helpful to taxpayers who:

- *wish to minimize their AGI so as to stay below the threshold for the 3.8% surtax on net investment income (AGI of $250,000 married, $200,000 single)*
- *do not itemize deductions or who have already maximized their permitted charitable contribution deductions*
- *live in a state that does not permit charitable deductions from state income tax, or*
- *can otherwise benefit from a lower amount of AGI*

5. Never give a yacht to a land-locked college

When you are making a gift of tangible personal property, remember that for the donor to receive a full fair market value deduction, the charity must use the donated property for its charitable purposes. So a yacht given to a nonprofit sailing school is fully deductible, but if that same yacht is given to a land-locked college, it will be hard pressed to put it to use. If the property is sold by the charity within three years of the gift, the deduction may be limited to basis. Detailed rules apply to gifts of tangible personal property, particularly if you want to make a "fractional" gift of just part of the property. If you fail to follow all of the rules, you can lose the deduction and penalties can also apply.

6. Don't forget to obtain a timely qualified appraisal for donated property

Except for publicly traded stock, charitable gifts of property with a value greater than $5,000 ($10,000 in the case of closely held stock) must be appraised by a "qualified appraiser" no sooner than 60 days before the date of the gift. If the donor does not have a qualified appraisal that meets all of the detailed requirements, the entire charitable contribution deduction can be lost. Note also that special appraisal rules apply to deductions over $500 for donations of used clothing and household items.

7. Run the numbers before you give

Gifts to charity are deductible from federal income tax under fairly complex rules, so it is always important to run the actual numbers. Your income tax savings from a particular charitable gift will depend on the kind of asset given, other charitable gifts made during the same year, your tax rate, whether you are in the alternative minimum tax (AMT), and whether any part of your charitable gift will be lost due to the itemized deduction "phase-out."

The itemized deduction phase out applies to common deductions, such as home mortgage interest, charitable contributions, and state and local income and property taxes. Under the phase-out rule, deductions by taxpayers with AGI above a threshold limit — $261,500 (single) or $313,800 (married), as adjusted for inflation — are reduced by the lesser of 3% of the income over the threshold or 80% of the total deductions.

It is widely expected that Congress will consider tax legislation in 2017. Thus, this year it will be particularly important to run the numbers based not only on current law but on possible tax law changes, which if enacted, could be retroactive to the beginning of 2017. Changes to the charitable contribution deduction or the itemized deduction phase out could impact tax savings from a gift. If income tax rates are reduced, for most taxpayers that would likely lower tax savings from deductions; but there still may be substantial income tax savings

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FIGURE 1

Permitted deductible charitable contributions

Charitable Gift Categories	Adjusted Gross Income [1, 3, 4]
Gifts of Cash to Public Charities and Certain Foundations • Colleges, universities, museums, hospitals, United Way-type organizations • Donor Advised Funds • Supporting Organizations • Conduit Foundations • Operating Foundations	**50%**
Gifts of Long-Term Capital Gain Property (including appreciated stock) to Public Charities and Certain Foundations	**30%**
Gifts of Cash to Private Foundations	**30%**
Gifts of Long-Term Capital Gain Property to Private Foundations Additional Limitations: Full fair market value deduction permitted only for gifts of qualified appreciated stock, which is stock traded on an established securities market.[2]	**20%**

[1] Adjusted gross income does not include income exempt from federal income tax

[2] Qualified appreciated stock is limited to 10 percent of the outstanding stock of a corporation, including all prior gifts made by donor and family members to any private foundations

[3] Does not address phase-out of deductions for higher income taxpayers

[4] Does not address alternative minimum tax

from properly structured charitable gifts. There is also a possibility of estate tax repeal, which would of course eliminate the estate tax deduction for charitable gifts. As noted above, donors planning very large gifts may want to defer finalizing the gift until the scope of any tax change becomes clearer.

8. Don't waste your gift by giving more than is deductible

When it comes to calculating the charitable contribution deduction, the tax law favors gifts to public charities over private foundations and gifts of cash over gifts of property. The deduction is limited annually to a percentage of AGI as shown in figure 1 above, with a 5-year carryforward.

Because your AGI limits your charitable contribution deduction, it's important to plan large gifts to take advantage of high AGI years. Don't give more than the permitted deductible limit, or at least plan to be able to use the 5-year carryforward. For example, an individual with AGI of $200,000 may make a deductible gift of $100,000 to a public charity, such as a university or museum, but may only deduct $40,000 of publicly traded stock given to a private foundation. And if both gifts are made in the same year, the large cash gift will "use up" the deduction, so the private foundation gift won't be currently deductible at all.

This is particularly important if you are anticipating a large income realization event—such as the sale of a business or capital gains from a large stock position. If you plan to make a large charitable gift, be sure to make it in the year of the sale to take advantage of your increased AGI. As noted earlier, it is important to monitor tax law change in 2017, as changes to the charitable deduction rules could change the expected tax consequences of a charitable gift.

9. Don't give money unrestricted if you have a special project in mind

Donors often assume that when a charitable relief agency solicits for gifts, it will go to the most current disaster. In fact, unless you specifically restrict your gift, or the charity's fundraising appeal expressly states that

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the funds donated will be used for a particular purpose, the charity can use the gift for any of its charitable activities. If you are giving to a relief organization because of a recent disaster, be sure to put explicitly on your check that your gift must be used for that particular relief project. Don't assume that the charity will do so.

10. Make sure you have a gift agreement for large charitable gifts

If you are making a major gift to a charity, for example, establishing an endowed fund or a scholarship fund, be sure to have a gift agreement specifying how the money will be used, and what will happen if the charity can no longer use it for the purposes specified. A gift agreement will cost money and effort upfront, but can save you unhappiness, and in the worst case, a lawsuit, if the gift doesn't go as expected. And without a gift agreement, you likely won't be able to bring a lawsuit, but must rely on the attorney general of the state where the charity is located to plead your case.

11. Follow the rules to a "T" for "split-interest" gifts

Sometimes a donor is not ready to part entirely with an asset, but would like to take advantage of making a charitable gift. The Internal Revenue Code has very detailed rules for making such gifts, and the gift will not be deductible from federal income tax if they are not followed very closely.

For example, you may still want income from investment assets, but you'd like to benefit a charity in a more permanent way than naming it in your will. A charitable remainder trust (CRT), if properly structured, allows a donor to keep income from the assets for the benefit of the donor or the donor's family, while leaving the remainder in trust for charity. Detailed rules govern CRTs, including, among other things, requiring them to have a payout in a specified form and amount. But a mistake as simple as providing for a 4% payout, rather than the required minimum of 5%, would disqualify the trust. The donor would lose the charitable deduction, and the trust itself would not be tax exempt.

12. Watch out for rising interest rates when creating a charitable lead trust

Like a charitable remainder trust, a charitable lead trust (CLT) is a form of "split-interest" gift that is specifically permitted under the federal income tax law. A CLT is the "opposite" of a CRT, providing a stream of income to charity for a term, and then leaving the remainder to family. The amount left to the family estate tax-free is likely to be greater when the interest rate used to value the charitable annuity paid to the charity is lower. With one interest rate increase from the Federal Reserve already and more expected, donors should consider creating CLTs sooner than than later. A donor who waits to fund a CLT until after rates have increased substantially will have much less chance of a successful outcome, as the "hurdle" rate for success will be higher.

13. Watch out for the private foundation self-dealing rules

Private foundations are tax-exempt charities that do not have broad public support or a purpose requiring significant involvement with the general public. Typically, most family foundations, which are funded by a single donor or family, are private foundations. Private foundations are subject to a number of additional restrictions on their operations and activities, including "self-dealing" rules that restrict private foundations from engaging in certain transactions with "disqualified persons." Disqualified persons include officers, directors, and trustees; substantial contributors; and certain related businesses and family members.

Not all self-dealing transactions are inherently unfair: for example, a disqualified person cannot sell property to a private foundation, even if it is a "bargain sale" providing a discount from fair market value. Although it seems counter-intuitive, don't fulfill a pledge with a gift from your private foundation. It is treated as the private foundation paying the debt of the donor, which is a prohibited act of self-dealing. Finally, don't pay family members more than reasonable compensation for working at the family foundation. Again, it would violate the self-dealing rules.

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14. Be sure to communicate with your family about your philanthropic legacy

Many donors create a private foundation or donor advised fund in order to have a lasting philanthropic legacy. But too often they fail to communicate with family members during their lives about their plans. Simply put, if you want a private foundation or donor advised fund to be a lasting family legacy, include your family in its planning and operations. If your family isn't involved in the charity you create during your life, or at your death, it may never become meaningful to them.

And if you plan to leave a large portion of your assets to charity, let your family know. This may not be an easy conversation to have. But when philanthropy is a surprise, it may leave instead a legacy of recrimination, unhappiness, and even litigation against the charity.

As with any other kind of planning, effective charitable giving is a combination of understanding your philanthropic goals and your family's financial needs, understanding the detailed tax rules that govern your gift, and communication with both the charity and your family so that your plan can unfold as you hope. By working closely with your advisors, you should be able to avoid the common mistakes discussed above and to make charitable gifts that are meaningful and tax-efficient.

Please do not hesitate to contact your relationship manager, call us at 866.627.7853, or visit our website at wilmingtontrust.com if you have any questions or would like additional information.

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