



## MEMORANDUM

To: Nonprofit Development Executives and Volunteers

From: The Sharpe Group

Re: IMPACT OF DECEMBER, 2010 TAX LAW CHANGES  
ON CHARITABLE GIVING

Date: December 20, 2010

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On December 17 the president signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This much-anticipated legislation features continuation of tax cuts that were scheduled to expire, extension of unemployment benefits, and other measures designed to stimulate the economy.

A number of provisions in the bill and their impacts will be of special interest to the nonprofit community. Many commentaries have thus far focused on incentives for immediate gifts from IRAs by donors over the age of 70 ½. The extension of the IRA Rollover provision first introduced in 2006 will give an immediate boost to charitable giving by older donors who can afford to give part of their retirement funds to charity. However, we believe the implications of the law will have a broader impact on charitable giving in both the near and long term.

In this paper we review the broad outlines of the bill as we believe it will affect charitable giving and introduce concepts those working with major donors of all ages will want to consider now and over the next two years. Other implications will no doubt surface as the bill is digested by practitioners, but we believe the following will be the primary areas of interest.

### **IRA Rollover Gifts**

The portion of the law with perhaps the most immediate impact on charitable giving is the extension of the ability for those over 70 ½ to make tax-favored gifts to charity directly from a traditional or Roth IRA. Unlike many of the other components of the bill, however, the IRA gift provision is only extended for gifts completed by the end of 2011.

Fortunately, however, it also provides retroactive benefits for gifts made in 2010. Because of the short time remaining to take advantage of this incentive for 2010, Congress has provided that donors can elect that transfers completed by January 31, 2011 be deemed made in 2010 for tax purposes, and those gifts will count toward the donor's 2010 minimum withdrawal requirements.

Because of the retroactive extension of this benefit to 2010, it will be possible for some married couples, if they act quickly, to give up to \$200,000 each from their IRAs, for a total of \$400,000. This opens an opportunity in some cases for accelerated payments on pledges that have been made by persons in the affected age and wealth category.

It is important to remember that this provision only applies to gifts from Individual Retirement Accounts and NOT from 401(k) plans or other tax-favored retirement planning vehicles. Nor may gifts be made to fund gift annuities or other life income gifts that benefit the donor or be transferred to donor-advised funds, supporting organizations, and certain other entities other than charities qualified to receive gifts under section 501(c) of the Internal Revenue Code. The rules affecting previously allowed IRA gifts pursuant to the Pension Protection Act of 2006 also apply to transfers made in 2010 and 2011.

#### **Other Gifts Fully Deductible**

There is also good news for those making traditional gifts of cash and other property whether outright or to fund charitable trusts, gift annuities or other planned gifts. The impact of a provision known as the "Pease Amendment," enacted in 1991, that had been gradually phased out in recent years was scheduled to be reinstated in 2011. This would have required higher income taxpayers to reduce their itemized deductions (including charitable gifts) by 3% of the amount by which their adjusted gross income (AGI) exceeded certain amounts. The legislation provides that the return of this reduction rule be delayed until January 1, 2013.

Other proposed changes in the law that would reduce the benefit of charitable deductions were fortunately not included in the bill. Of special interest is the fact that no limits were placed on the amounts that can be deducted by higher income taxpayers.

Administration budget proposals over the past year would have limited the savings from charitable gifts, mortgage interest, and other deductible items to the 28% tax bracket. That would have increased the after-tax cost of giving for donors in higher tax brackets. While this provision may resurface in future discussions of long-term reform of the federal income tax code, it did not find its way into the recently enacted legislation.

## **Estate and Gift Tax Changes**

Had Congress not acted, the sunset provisions included in 2001 tax legislation would have resulted in a large increase in federal estate and gift taxes on January 1, 2011. The estate tax exemption would have dropped to \$1 million per person (\$2 million for a couple with minimal tax planning) and estates worth more than the exempted amount would have been taxed at a top rate of 55%. This would have subjected a much larger number of estates to taxation, and more of a decedent's estate assets would have been consumed by payment of estate tax on amounts left to family members and other noncharitable beneficiaries.

For donors whose plans provided for gifts to charity based on what remains after gifts to heirs, and payment of estate taxes, the return of higher estate taxes would have resulted in less of a remainder for charitable beneficiaries.

The administration proposed extending the 2009 law allowing a \$3.5 million per person exemption for gifts at death and a \$1 million exemption for gifts completed during lifetime. The maximum tax rate would have continued at 45%.

But in the final compromise and what is arguably the only substantial new tax cut in the final legislation, Congress decided to increase the amount each person could leave to non-charitable heirs to \$5 million per person, or \$10 million for a married couple and reduced the maximum rate to 35%.

Under prior law the exemptions were available to a married couple on a "use them or lose them" basis. If one spouse passed all of their assets to the survivor under the marital deduction and did not therefore need to use his exemption, the second spouse to die had only the benefit of his or her own exemption. Under the new legislation, the exemption amount is "portable" between spouses. If one spouse does not use the exemption in his estate, it can be claimed by the survivor.

Under prior law, it was necessary to create trusts to assure the use of the exemption of the first spouse to die and in so doing deprive the survivor of full access to the funds in trust. That planning will no longer be required to assure the full use of both spouses' credits.

Another major change is the "reunification" of the gift and estate tax systems. Since 2002, the federal gift and estate tax changes have been "decoupled." This meant that the \$1 million exemption for amounts one could give to heirs during lifetime has been significantly less than the amount that could be left at death, some \$3.5 million in 2009.

Under the new law, the two systems are brought back into alignment and it is possible to give up to \$5 million during lifetime or at death. If a decedent has used the \$5 million exemption during lifetime, there is no exemption available at death.

This is perhaps the provision that can be expected to have the greatest impact on charitable gift planning. Support can be found in some quarters for the proposition that the impact could be negative. Others, including some prominent academic studies, would indicate that the impact could be positive. It is a classic "half empty, half full" question.

One school of thought predicts that the ability to leave more to loved ones tax free will result in significant declines in charitable bequests. The argument is that it will no longer be necessary for many wealthy individuals to leave money to charity just to save taxes.

If you approach the subject from the assumption that when the "cost" of something goes up, the demand for it will fall, then you can make an argument that the lower estate tax rates will lead to fewer charitable bequests.

Let's look at a simplified example. Suppose the maximum estate tax rate is 45% and someone leaves \$1 million to charity. Their estate will save \$450,000 in taxes as a result of making the bequest. In this case the charity receives \$1 million and the government receives nothing. But wait - the person's non-charitable heirs don't receive anything either. In this case the after-tax "cost" to the family is \$550,000. That is what the family would have received if the charitable bequest had not been made.

Perhaps there are people who will choose to deprive their families of \$550,000 for no other reason than to make certain the government doesn't get any of their estate.

History shows, however, that most wealthy persons choose to incur estate taxes and leave the remainder after tax to families. Over many years, IRS reports indicate that only approximately 20% of persons with taxable estates choose to leave anything to charity. If it didn't "cost" anything to leave funds to charity, this number would certainly be much higher. The 20% who leave funds to charitable beneficiaries must have donative intent because their heirs would receive more if they did not make the charitable provisions. Even if the estate tax were 90%, heirs would still receive *something* if no charitable gifts were made.

The opposing argument to be made is that the reduction in estate taxes will not result in reduced amounts given to charity at death, and may, in fact, increase it. Take the case of a wealthy 80-year-old individual with a \$75 million estate. He had decided to leave \$10 million to each of his three children with the remainder after tax to be split among four charitable beneficiaries. He has informed each of the charities of his intention and has accepted recognition for these gifts. If a 50% tax on the amount left to the children were \$30 million (requiring \$60 million pretax), there would be \$15 million available for the charities

Now suppose the estate tax is eliminated. What could be expected to change in this donor's plan? The children would not be affected by the lack of estate taxes. Each still receive \$10 million as planned. But now no tax would be due on their portion, so the charities would receive \$45 million, including the \$20 million that would have previously been owed in estate tax. The following chart illustrates the outcomes with and without an estate tax:

| <b>How Assets<br/>Are Distributed</b> | <b>With<br/>50% Estate<br/>Tax</b> | <b>With<br/>No Estate<br/>Tax</b> |
|---------------------------------------|------------------------------------|-----------------------------------|
| <b>Value of Estate</b>                | \$75 M                             | \$75 M                            |
| <b>Amount Paid In Tax</b>             | \$30 M                             | \$0                               |
| <b>Amount to Children</b>             | \$30 M                             | \$30 M                            |
| <b>Amount To Charity</b>              | \$15 M                             | \$45 M                            |

In this case, the father might, in fact, decide to change his plans to increase the amount the children would receive. Experienced wealth managers know, however, that many among the wealthy choose how much they want their heirs to receive, make plans to pay the tax on that amount, and leave the remainder to charities.

The after-tax cost argument can also be reversed. Take the case of a person who makes a specific \$1 million commitment to charity from a \$10 million estate as part of her plans. The \$1 million bequest would be deductible from the estate with the remainder to children after payment of a 35% estate tax on the amount they receive.

If there is no longer any tax on their portion of the estate, they receive the full benefit of lower estate taxes while the charity still receives the \$1 million. Arguably the “cost” of the bequest to the family actually goes down as they receive more of the estate because the amount that would have been paid in taxes is no longer due.

| <b>How Assets<br/>Are Distributed</b> | <b>With<br/>35% Estate<br/>Tax</b> | <b>With<br/>No Estate<br/>Tax</b> |
|---------------------------------------|------------------------------------|-----------------------------------|
| <b>Value of Estate</b>                | \$10 M                             | \$10 M                            |
| <b>Amount To Charity</b>              | \$1 M                              | \$1 M                             |
| <b>Amount Taxable</b>                 | \$9 M                              | \$0                               |
| <b>Amount Paid In Tax</b>             | \$3.15 M                           | \$0                               |
| <b>Amount to Children</b>             | \$5.85 M                           | \$9 M                             |
| <b>Percent To Children</b>            | 59%                                | 90%                               |

A series of studies over the years by The Center on Philanthropy at Indiana University bear out this latter argument. The Center is best known for its work in preparing annual Giving USA reports. The most recent survey, “*The 2010 Bank of America Merrill Lynch Study of High Net Worth Philanthropy*” may be accessed at <http://www.philanthropy.iupui.edu/>.

In surveys of the wealthy in 2005, 2007, and 2009 the participants were asked how a complete elimination of the estate tax would affect their charitable plans. Over the time period, an average of 91% said their charitable bequests would stay the same or increase. In fact, each successive survey found that a larger percentage said they would increase their bequests, with the number of persons saying they would “dramatically” increase their charitable bequests growing the most over time.

| <b>Year</b>    | <b>Dramatically<br/>Decrease</b> | <b>Somewhat<br/>Decrease</b> | <b>Stay<br/>The Same</b> | <b>Somewhat<br/>Increase</b> | <b>Dramatically<br/>Increase</b> |
|----------------|----------------------------------|------------------------------|--------------------------|------------------------------|----------------------------------|
| 2005           | 1.4%                             | 4.9%                         | 61.4%                    | 18.1%                        | 14.2%                            |
| 2007           | 2.1%                             | 7.8%                         | 54.0%                    | 24.6%                        | 11.5%                            |
| 2009           | 1.7%                             | 7.8%                         | 47.5%                    | 26.0%                        | 17.0%                            |
| <b>Average</b> | <b>1.7%</b>                      | <b>6.8%</b>                  | <b>54.3%</b>             | <b>22.9%</b>                 | <b>14.2%</b>                     |

The research thus suggests that charitable bequests may continue at prior levels, or even increase, with lower estate taxes. For example, with no estate tax due, the donor in the case of the \$10 million estate discussed above could conceivably increase his bequest by 100 percent to \$2 million and his children would still receive \$8 million, some 38 percent more than they would have under prior estate tax law.

Those who work in the field of gift planning know that the vast majority of charitable bequests traditionally come from those who for many years have been free from concerns about taxes on their estates.

In recent years an estimated 200,000 persons annually leave bequests to charity. Fewer than 5,000 of them have taxable estates. Thus, over 97% of bequests already come from non-taxable estates. True, a large percentage of the money that is bequeathed comes from taxable estates, but the IRS reports that a large share of that money is bequeathed to foundations rather than directly to charities. Therefore, any impact of a reduction in bequests by the wealthy could be expected to have less of an immediate impact on front-line charities.

Keep in mind also that many states will still impose gift and estate taxes and some predict that some state legislatures may move into the "tax space" being vacated by the federal government. In that case, the first tax dollars on an estate may go to state governments with the federal government only exacting an additional tax on the largest estates. For those who believe that estate tax incentives are necessary to motivate gifts at death, few believe that governments at all levels will permanently abandon this revenue source.

### **New Planning Opportunities**

It is important to note that the changes Congress made to the estate and gift tax laws are not permanent. The adjustments to the estate tax rates and exemptions are only for persons who pass away before December 31, 2012, so the planning opportunities surrounding the increased exemption at death are relatively limited.

The immediate opportunities for estate and gift planning by the wealthy pertain to the reunification of the gift and estate tax laws. Recall that a married couple will now be able to transfer up to \$10 million free of gift tax over the two-year period the provisions of the recent law are in place.

If they have already transferred \$1 million each under the old gift tax exemption available through 2009, they will now be able to transfer an additional \$4 million each, for a total of \$8 million. For wealthier individuals this is an opportunity to permanently remove assets from their estates. Should Congress raise the estate and gift taxes in the future, those assets already will have been transferred!

Some who are charitably inclined will choose to make gifts in various ways that result in meeting personal objectives while also making significant charitable gifts. Experienced gift planners know that donors often would like to create a gift annuity or a charitable trust to benefit a loved one other than a spouse for life or a period of years. They will sometimes fail to follow through, however, when informed there would be gift tax due on the value of the income interest given to a non-spouse.

In the case of a \$500,000 gift annuity for the benefit of a 75-year-old sister, for example, a donor would enjoy a \$190,000 income tax deduction, but there would be a taxable gift of the remaining \$310,000 to the sister. If they have already used the \$1 million gift tax exemption amount available through 2009, they may be pleased to learn they will now have an additional \$4 million available to offset such gifts they complete during their lifetime. Well-advised donors will be interested in ways to make significant charitable gifts while they also provide for loved ones in a tax-efficient manner.

Another change in planning strategies that may come about as a result of the new legislation is a reversal of the way people have handled the potential taxable gift element when structuring charitable remainder trusts and other gifts that benefit persons other than the donor and/or their spouse. It has become common for donors to retain the right to revoke through their will another person's right to receive income to avoid triggering a taxable gift at the time the trust is created.

Over the next two years, some may choose to omit a right of revocation in order to make sure a taxable gift is "locked in," thereby making it possible to use a portion of the new exemption while it is available.

Another point that will be of interest to those working with individuals planning charitable remainder trusts is the fact that the new law removes section 2511(c) from the Internal Revenue Code. This removes what was considered an impediment to the completion of certain trusts.

Donors who would like to transfer amounts in excess of the \$5 million exemption may find a charitable lead trust to be an attractive alternative. If, for example, a donor funds a \$10 million charitable lead annuity trust paying 5.5% for ten years, they will be making a gift of \$5.5 million at the rate of \$550,000 per year over that time frame. The charitable gift tax deduction under today's historically low AFMR rate would be \$5 million, leaving a taxable gift of \$5 million. The net result is to transfer the amount remaining in the trust to heirs free of gift and estate tax (\$10 million if the trust earns at least 5.5%), after first making a \$5.5 million gift to charity. This will undoubtedly be one of the ways that some choose to structure significant charitable transfers over the next two years while the \$5 million "window of opportunity" is open.

In addition to the extension of current tax brackets for taxpayers of all income levels through 2012, Congress also continues the favorable tax treatment for capital gains and qualified dividend income. In the case of charitable lead trusts, some donors may choose to fund those trusts with appreciated assets, liquidate the assets inside the trusts at a 15% capital gains tax rate and diversify for greater growth that will ultimately pass tax free to heirs.

### **When the dust settles**

Looking to the future, we can expect many wealthy donors to transfer the maximum amounts permissible to heirs during the next two years. When they die they will then not have any unified credit left to shield any of their estate from tax. That means the first dollar left in their estate is subject to tax at 35% (or whatever the rate will be). This will result in a greater incentive for some to make charitable dispositions at death because they used their unified credit to transfer assets to heirs during lifetime.

From a charitable planning perspective, the net result of the estate and gift tax changes in the near term may, therefore, be to encourage the funding of trusts and other life income gifts for nonspousal heirs, creation of charitable lead trusts that help leverage the gift tax exemption, and other plans that serve to take maximum advantage of what may be temporary provisions.

Returning to the extension of the IRA Rollover opportunity, keep in mind that this may be the best "pocket" from which to make charitable gifts over the next year as donors in many cases will be transferring to heirs other assets that might have otherwise been donated to charity. They can't give the IRA funds to heirs during lifetime in any event so this can be a way to continue their giving while taking advantage of the newly expanded incentives to give to loved ones.

As we move into next year, other ramifications of the new tax law will undoubtedly emerge. In the meantime, the first priority for many should be to make sure donors act to take advantage of the ability to make 2010 IRA gifts if they complete them by January 31, 2011.

Looking at the broader opportunities, many have predicted that there will be an unprecedented level of estate planning activity over the next two years. Many older donors will be making what will prove to be their final estate plans. For that reason it is more important than ever to communicate your need for long term funding to the broadest group of older donors possible so you remain top of mind when their advisors ask if they have charitable interests as part of their planning.

For nonprofit development executives who pause to digest the meaning of the new law in light of the makeup of their constituency and other factors, the next year could present unprecedented opportunities for raising significant sums. Changes in the tax laws always bring a period of uncertainty.

Pundits predicted dire consequences from the estate tax reductions in 1981, 1986, and 2001. Despite those predictions charitable gifts from estates have grown dramatically since 1981. Changes in death rates and asset values have proven to have a greater impact over time on the number and amount of charitable bequests.

History reveals the philanthropic spirit that springs from America's unique blend of the roles of government and the nonprofit sector will continue unabated.

The issues inherent in the convergence of philanthropy and estate planning are not new. The 1916 annual report of the Boston Children's Aid Society, published before there were any income or estate tax incentives for charitable gifts stated, *"Since the foundation of the Society many legacies, bequests, and special gifts have come from friends who have taken this means of helping needy children. It is best that a Society such as this should have to depend upon the general contributing public for a large part of its yearly receipts, for in this way it is most likely to meet changing needs and conditions, and be eliminated if its services are of no value."*

Even today, nearly a century later, the wisdom of this statement continues to be sound. As always, the most appropriate tools and the best assets to fund gifts will change over time. The period we are now entering will be no exception.