SIGMA INVESTMENT COUNSELORS

Sigma Summaries

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Charitable Gifting

Americans have always been generous in their giving. In 2001, an estimated $212 billion was given to charities. Individuals contributed 76%, followed by foundations at 12%, bequests at 8% and corporations at 4%. According to research conducted by the American Association of Fundraising Counsel, individuals continue to give even during the current economic slowdown.

Many individuals provide financial support to national organizations such as the United Way, the American Cancer Society or the MDA. Others rally around a particular event as evidenced by the tremendous outpouring of support in funding multiple charities supporting families impacted by the events of 9-11. Locally, our churches, synagogues, food banks and shelters are dependent upon individual support by members who live within the very community in which they serve. On a more personal level, many people have a "cause" that is near and dear to their heart as a family member or close friend may have been inflicted with a particular illness. I know first hand the struggle, both physically and emotionally; one goes through when dealing with a particular illness. I have a sister who is a breast cancer survivor and I have made this cause a priority in my own gifting. Regardless of the circumstances, non-profit organizations provide a much-needed conduit to assist those in need.

While the motive to provide financial support to charities is driven by a philanthropic intent of the donor, there are tax and estate planning benefits that should be considered when making sizable gifts. The focus of this Sigma Summary is to address some of the more popular strategies that are often employed to take advantage of these benefits.

Outright Gifts: Perhaps the simplest form of gifting is when one makes an outright gift directly to a charity. These gifts are commonly made with cash but may also involve marketable securities or any other asset with economic value. Keep in mind that the donor is required to maintain a copy of a signed receipt from the non-profit organization for any contribution made in excess of $500 to be eligible for the deduction on that individual's tax return.

A very popular technique when making outright gifts is the pledge of appreciated securities in lieu of cash. For example, assume that an individual owns 100 shares of Microsoft that was purchased 15 years ago for $5 per share. If the individual sells the stock for $25 per share, he will realize a $20 per share capital gain and under most circumstances, be responsible for paying $4 per share in capital gains taxes. After tax, the individual realizes $21 per share or $2,100 on the sale of the 100-share lot. If, by example, this individual wished to contribute a similar amount to his local church or charity, by gifting stock in place of cash, the IRS would recognize the full value of the stock, equal to $25 per share, or $2,500, thereby increasing the charitable deduction. Moreover, the charity would not have to pay any capital gain tax on the subsequent sale of the stock given their tax-exempt status.

Donor-Advised Funds: Donor-Advised Funds come in a variety of shapes and sizes and are becoming increasingly popular given the ease of administration, low cost structure, relatively low minimums, and ability to separate the funding process from the gifting process. Examples include the Community Foundation of Southeastern Michigan as well as the Schwab and Fidelity Charitable Gift Funds.

Essentially, Donor-Advised Funds represent a commingled portfolio that is comprised of a large number of "individual accounts". Donors can fund the account with either cash or marketable securities and typically, has an option in how their money will be invested. The value of the gift is equal to the market value of the cash or securities on the day the gift was made. These monies may appreciate or depreciate in value based on the manner in which the gift was invested. While the assets may be commingled for investment purposes, the assets are segregated from an accounting perspective so each donor knows the exact value of his account. At the donor's choosing, proceeds from the account can be earmarked for a specific charity.

One of the attractive features of Donor-Advised Funds is that the donor can separate the funding of the gift from the gifting process. For example, an individual once again owns many shares of Microsoft. His cost basis remains $5.00 per share. When the stock hits $25.00 per share, the donor elects to use this asset to fund a Donor-Advised Fund. For IRS purposes, a charitable gift was made at the time that the shares of Microsoft were transferred into the account. However, the donor may not have a particular charity in mind when the gift was made. In fact, several years may go by before any funds are distributed from the account. This time lag is entirely acceptable within the confines of Donor-Advised Funds.

Private Family Foundations: Private Family Foundations have similarities with Donor-Advised Funds but there are distinct differences, as well. For example, it is common to fund Donor-Advised Funds for as little as $10,000 whereas Private Family Foundations are typically larger in size, beginning at $100,000 but more commonly, are valued at multiples of this amount. While there exists a separation as to when the gift is made into the Foundation and when the gift is paid out to a charity, foundations typically distribute a minimum of 5% of its market value each year to retain its tax-free status.

In addition to size, Private Family Foundations typically appeal to those individuals who would like to retain the most control over their gifting. It is also an attractive vehicle for those who wish to involve future generations in the management and decision making of the Foundation. Whereas this method of gifting has historically been reserved for a very small number of high net worth individuals and their families, turnkey solutions are being developed that are simplifying the administration and lowering the cost.

For example, assume a family owns a sizable position in Microsoft worth $500,000. This stock may have a very low cost basis so upon sale, would result in a sizable capital gain. Instead, the family may wish to use this stock to fund a Private Foundation. Once again, the value of the gift is equal to the market value of Microsoft on the date of the transfer. Typically, family members sit on the board of the Foundation, select the charities that will receive the grants, determine the size and timing of the gifts, and may oversee the management of the portfolio as well. In addition, board members may be compensated for their time and effort. This allows a maternal or paternal donor to engage other family members to become vested in the charitable act.

The downside of Private Foundations includes the initial start-up cost ranging from $5,000 to $25,000, the ongoing administrative and fiduciary responsibilities to insure that the foundation remains in compliance, as well as the fact that Private Foundation grants as well as its financial operations are of public record.

Charitable Remainder Trusts (CRT): A Charitable Remainder Trust is an estate planning technique whereby an individual funds an irrevocable trust with cash or marketable securities. The intent is for this trust to distribute a stream of income to designated beneficiaries for a pre-determine time period. At the end of this time period, whatever value is remaining in the account is distributed to charity.

What makes a CRT different from the other techniques highlighted above is the fact that the entire amount of the gift is not earmarked for charity. Rather, the portfolio is designed to provide an annual cash flow back to the donor for a specified time period and only the remainder left in the account, once the time period is exhausted, goes to charity.

This has several ramifications. For example, the charitable deduction will be less than 100% of the value of the initial gift as the income recipient is likely to receive a partial recovery of principal. In addition, the resulting cash flow is subject to income and capital gain taxes.

Once again, an example may best illustrate the point. Let's assume that an individual owns $500,000 of Microsoft with very low cost basis. Keep in mind that Microsoft only recently began paying a dividend and its current yield is less than 1.0 percent. Moreover, the individual may have a sizable estate and is charitably minded.

By establishing a Charitable Remainder Trust and funding it with Microsoft stock, the individual can accomplish several goals. First, Microsoft can be sold within the CRT without any immediate capital gain implications. The proceeds from the sale can be reinvested in a diversified portfolio of stocks and fixed income securities such that the portfolio can sustain a stream of income, typically in the 5% to 8% range. The donor can also receive a charitable deduction for the gift, albeit less than had he made a present day gift. The donor's taxable estate has also been reduced yet he can continue to receive a stream of income from assets that will not be subject to taxes at his death.

While there are several varieties of Charitable Remainder Trusts, the two most commonly used ones include the following:

- Charitable Remainder Annuity Trust (CRAT): A CRAT pays a fixed annual annuity of at least 5% on the *initial* fair market value of the trust to the non-charitable income beneficiaries. This fixed payout will not change over the life of the trust regardless of the future value of the underlying portfolio.

- Charitable Remainder Unitrust (CRUT): A CRUT pays the non-charitable income beneficiaries a fixed percentage of at least 5% of the value of the trust. This distribution is recalculated on an annual basis. Therefore, the distributions from the trust can very as the market value of the portfolio changes.

Charitable Lead Trusts (CLT): A CLT is the opposite of a CRT in that the trust pays out a stream of income to charity for a specified period of time. Once the time period ends, the remaining principal in the account is distributed to the remainder beneficiary, typically individuals related to the donor. As with the CRT, a Charitable Lead Trust can pay out a fixed dollar amount or a fixed percentage of the market value.

Recent legislation: The Senate approved the Charity Aid, Recovery, and Empowerment (CARE) Act of 2003 by a vote of 95 - 5. If enacted, this legislation would contain $13 billion in tax cuts to encourage donations to charities. One of the key elements of the CARE Act is that individuals older than 70 1/2 would be able to withdraw money from their IRA's and other retirement accounts and donate the assets directly to a charity (including a donor-advised fund) without being subject to income tax. Individuals would also be allowed to make tax-free retirement account distributions to "split interest" charitable vehicles such as charitable remainder trusts, pooled income funds and charitable gift annuities beginning at age 59 1/2.

When considering one's options regarding charitable giving, it is advisable to consult with a tax specialist or attorney specializing in estate planning. While we recognize that charitable gifting fulfills one's philanthropic intent, there are multiple strategies that may be available to maximize the size of the gift, minimize taxes or provide other estate planning objectives. Proper planning can prove invaluable in this process.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.

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