PALLAS
CAPITAL ADVISORS

Doing Well by Doing Good

Planning Commentary December 2020

CHARITABLE PLANNING IN 2020

With the holiday season upon us and the end of the year approaching, it is time to look forward to being together with friends and family, even if our gatherings are limited by some form of social distancing this year. It is also a time when charitable giving often comes to mind. The tax benefits associated with charitable giving could potentially enhance your ability to give and should be considered as part of your year-end tax planning.

In this month's newsletter, we will provide a general overview of income tax considerations around charitable planning, along with a brief discussion of common charitable giving methods and planning strategies.

TIMING IS EVERYTHING

When we take the topics of charitable giving and income taxation, and then look at them through the lens of year-end planning, we must come back to the question of whether or not we believe that income tax brackets will change dramatically next year under President-elect Biden's tax policies. A taxpayer's outlook on the future of tax policy may impact his or her decision as to when to take a tax deduction.

Typically, you have a certain amount of control over the timing of income and expenses at the end of the year. You generally want to time your recognition of income so that it will be taxed at the lowest rate possible, and time your deductible expenses so they can be claimed in years when you are in a higher tax bracket.

For example, if you expect to be in a higher tax bracket next year, it may make sense to wait and make the charitable contribution in January so that you can take the deduction next year when the deduction results in a greater tax benefit. Or you might shift the charitable contribution, along with other deductions, into a year when your itemized deductions would be greater than the standard deduction amount.

TAX DEDUCTION FOR CHARITABLE GIFTS

If you itemize deductions on your federal income tax return, you can generally deduct your gifts to qualified charities. However, keep in mind that the amount of your deduction may be limited to certain percentages of your adjusted gross income (AGI). For example, your deduction for gifts of cash to public charities is generally limited to 60% of your AGI for the year, and other gifts to charity are typically limited to 30% or 20% of your AGI. Charitable deductions that exceed the AGI limits may generally be carried over and deducted over the next five years, subject to the income percentage limits in those years.

THE CARES ACT IN 2020

The Covid-19 pandemic saw Congress create the CARES Act earlier this year, which provides some special incentives for giving in 2020:

- **Above-the-line deduction for non-itemizers.** A $300 above-the-line charitable deduction for filers who do not itemize is allowed for cash gifts to qualified charitable organizations in 2020.
- **Suspension of limitation for itemizers.** For 2020, the individual limitation of 60% of AGI for cash gifts to public charities is raised to 100% of AGI. (This does not apply to donor-advised funds.) This deduction is reduced dollar for dollar with other itemized donations—for example, a donor who contributes both cash and property is limited to a total deduction of 100% of AGI.
- **Increased limitation for corporate donors.** Corporations also have higher limits for 2020 cash gifts—25% of AGI, up from the usual 10%.
- **Increased limitation on food donations.** The limitation on charitable donations of food is 25% of AGI in 2020, up from 15%.

GIVING METHODS AND STRATEGIES

Qualified Charitable Distribution (QCD):

A Qualified Charitable Distribution (QCD), often referred to as a "charitable IRA rollover," is a direct transfer by an individual over age 70½ from an IRA to a qualified charity. The charity must be a public charity or private operating foundation that can receive general contributions (not a Donor Advised Fund or a §509(a) Supporting Organization). The QCD must otherwise have qualified as a charitable income tax deduction. A person can direct up to $100,000 per year in this manner, and the distributed amount is excluded from income so the taxpayer does not need to report the distribution as taxable income for federal tax purposes. Furthermore, the distribution counts toward the taxpayer's annual required minimum distribution if one is due.

Private Family Foundation:

A Private Foundation is a tax-exempt organization (a trust, corporation, or hybrid) in which a donor creates, funds, and controls for the primary purpose of making grants to charities and/or individuals. A Private Foundation funded during the donor's lifetime can provide philanthropic recognition to the donor and family. Through the management of the foundation, it can instill in the donor's heirs a sense of social awareness and responsibility that might not otherwise be present, while allowing them to be paid for their work on the governing board.

Donor Advised Fund:

Similar in some respects to a private foundation, a donor advised fund offers an easier way for you to make a significant gift to charity over a long period of time. A Donor Advised Fund (DAF) is a charitable investment account that provides simple, flexible, and efficient ways to manage charitable giving. The money that goes into a Donor Advised Fund becomes an irrevocable transfer to a public charity with the specific intent of funding charitable gifts. This public charity serves as the administrator of the DAF. The Donor may be an individual, family, trust, Private Foundation, or corporation. The Donor may make grant recommendations or provide advice on distributions from the fund to qualified charitable organizations. The DAF is free to accept or reject the recommendations.

CHARITABLE GIVING COORDINATED WITH ESTATE PLANNING

Charitable giving can play an important role in many estate plans. Philanthropy can not only give you great personal satisfaction, it can also give you a current income tax deduction, let you avoid capital gains tax, and reduce the amount of taxes your estate may owe when you die.

Will or trust bequests and beneficiary designations:

These gifts are made by including a provision in your will or trust document, or by using a beneficiary designation form. The charity receives the gift at your death, at which time your estate can take the income and estate tax deductions.

Use of qualified plan as testamentary gift:

Naming a charity as the beneficiary of your retirement account(s) is one of the most tax-efficient ways to make philanthropic gifts. The charity does not pay income tax on assets from a retirement account, which allows more dollars to be used by the charity for its purposes. Those are dollars that would have been partially reduced by income tax if left directly to your heirs. Bottom line, if you want to leave money to both family and charity at death, it is usually better to leave tax-deferred accounts to charity.

Use of life insurance for charitable planning:

A gift of life insurance can make a major charitable gift a cost-effective option. To get an income tax deduction, the donor must transfer complete ownership of the policy to the charity during life. The donor's cash gifts to charity for subsequent premium payments (if any) are also deductible subject to limitations based on adjusted gross income.

If the donor continues to own the policy and simply names the charity as beneficiary, no income tax deduction is allowed; however, the donor's estate can deduct the charitable gift of the proceeds for estate tax purposes.

The value of a gift of a life insurance policy is the lesser of the fair market value of the policy or the donor's cost basis in the policy. The deduction ceiling is 60% of adjusted gross income for premium amounts transferred to the charity in cash, and 30% of AGI for premiums paid directly to the life insurance company (for the use of the charity).

Charitable trusts:

No discussion of charitable planning should leave out the use of charitable trusts. With trusts, you can name the charity as the sole beneficiary, or you can name a non-charitable beneficiary as well, splitting the beneficial interest (this is referred to as making a partial charitable gift). The most common types of trusts used to make partial gifts to charity are the charitable lead trust and the charitable remainder trust.

CHARITABLE LEAD TRUST

The charitable lead trust (CLT) is a trust arrangement under which an annual income from the trust is paid to a qualified charitable organization for a specified period of years, with the principal of the trust passing to noncharitable beneficiaries (often the children or grandchildren of the donor) when the trust terminates. Thus, the lead trust is a technique for making a "temporary gift" of income to a charitable institution and eventually passing the property to individual beneficiaries.

CHARITABLE REMAINDER TRUST

A charitable remainder trust in some ways is the mirror image of the charitable lead trust. Trust income is payable to you, your family members, or other heirs for a period of years, then the principal goes to your favorite charity.

Time and space do not permit us to discuss the many details around the charitable remainder and lead trusts. An individual should always seek the advice of tax and legal counsel when considering more advanced strategies that employ trust instruments.

GIFTS OF ARTWORK

While not as common, the donation of artwork that has significant value may also be considered by individuals. There are several tax-planning issues that should be considered before giving artwork to charity.

Getting a charitable contribution deduction:

To obtain a charitable contribution deduction equal to the fair market value of the work of art, the work must be donated to a public charity or private operating foundation, and the donor must anticipate that the charity's use of the work will be "related" to its exempt purpose.

In some instances, a charitable contribution of artwork can lead to income recapture if the donation to the charitable organization exceeds $5,000 and the organization disposes of the artwork within three years of the donation. The donor can avoid this harsh penalty by requesting a specific written certification from the recipient organization, under penalties of perjury, certifying that their use of the artwork was substantial and related to its exempt purpose.

It is important to understand the intended future use of your donated artwork as that may have an impact on your tax deduction. For example, a gift of a painting to a museum would clearly be a related use gift. A gift of a work of art to a school with a museum, which uses it for art instruction, may also be a related use gift. However, if the work of art is contributed, for example, to the local SPCA, which in turn just plans to sell the art, the amount of the deduction would likely be limited to its cost basis, because the gift would not be related to the organization's exempt purpose.

The contribution is deductible up to 30% of adjusted gross income ("AGI") for donations to a public charity, with any excess contribution deductible over the following five years (limited to 30% of AGI) until exhausted.

Artwork must be considered long-term capital property to qualify for a tax deduction based on its fair market value. To claim a work's current fair-market value as the value of the charitable deduction, you must have held the property for longer than one year.

Getting art appraised:

IRS regulations state that a gift of property (other than cash or marketable securities) that has a value exceeding $5,000 requires that the beneficiary obtain a qualified appraisal, no earlier than 60 days before the gift is made and no later than the due date of the tax return on which the deduction is claimed. In addition, a donor must also complete IRS Form 8283 if the amount of the deduction for non-cash gifts is more than $500. The donor is also required to maintain records of the contribution, as specified in IRS regulations.

Donations of art at death:

For testamentary gifts of art, the estate tax charitable deduction is unlimited, and the related- use rule does not apply, which may produce a larger tax benefit than a lifetime gift of art. In addition to the estate tax savings, it also removes an illiquid, difficult to value, and perhaps unwanted (from the heirs' perspective) asset from the estate.

REMEMBER TO DOCUMENT YOUR CHARITABLE DONATIONS

Make sure to retain proper substantiation of your charitable contribution. To claim a charitable deduction for any contribution of cash, a check, or other monetary gifts, you must maintain a record of such contributions through a bank record or a written communication (such as a receipt or letter) from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution.

If you claim a charitable deduction for any contribution of $250 or more, you must substantiate the contribution with a contemporaneous written acknowledgment of the contribution from the charity. As outlined earlier, if you make any noncash contributions, there are additional requirements.

A WORD OF CAUTION

Be sure to deal with recognized charities and be wary of charities with similar-sounding names. It is common for scam artists to impersonate charities using bogus websites, email, phone calls, social media, and in-person solicitations. Check out the charity on the IRS website, irs.gov, using the Tax Exempt Organization Search tool.

IN SUMMARY

Doing well by doing good is very important to many individuals. Public and private charities are absolutely critical to maintaining the social fabric of the communities around us, and the nation as a whole. Because of that, the IRS encourages charitable giving by permitting an income (or estate) tax deduction to the donor. Understanding, at least at a basic level, the rules of the road will help taxpayers take advantage of every helping hand the IRS may occasionally extend.

You may enjoy listening to the latest *Pallas Perspective* podcast, with the CEO of Wheels Up, Mr. Kenny Dichter, and a discussion around some of their philanthropic initiatives. You can access that podcast here.

Sincerely,

James Landry, ChFC
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Director of Planning
Pallas Capital Advisors