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FACT SHEET

L-954

Better Estate Planning

CHARITABLE GIFTS

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Estate Planning attempts to create an equitable compromise between minimizing the amount of taxes due, distributing the property as desired to the designated heirs and assuring a financial source of security.

This fact sheet on Charitable Gifts in Texas was prepared by Eugene M. McElyea, L.L.B., College of Business, Texas A&M University and consultant to the Texas Agricultural Extension Service program for this series of fact sheets on Estate Planning.

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Giving to charitable organizations has become a part of the American way of life. Because government recognizes the valuable contribution these groups make to society, it encourages giving to such enterprises and allows deductions for gifts on tax returns. There are income, estate and gift tax savings which arise when one gives money to charity. In some instances it may be possible to save money by giving it away.

Most people make gifts to charitable groups because of their appreciation for the type of service which the charity provides. Generally a secondary consideration is the fact that donors also receive tax benefits. While most donors are not motivated to give to charity because of tax benefits it is important that donors are aware of the role charitable donations play in one's personal and financial planning.

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Initially it is important to consider the type of gift qualifying as "charitable" by taxing authorities. The gift must be made to a qualifying organization generally defined as being engaged in non-profit religious, charitable, scientific, literary or educational endeavors. Gifts directly to needy individuals and families might indeed be a charitable act but such direct giving unfortunately does not qualify for a tax deduction. The Internal Revenue code makes a distinction between certain types of charitable organizations and allows a greater income tax deduction for donations to some than it does to others.

Under the old law a donation limit of 20 percent of an adjusted gross income existed, but if one donated at least 10 percent to a "public charity" including organizations supported by public donations such as churches, educational institutions, hospitals or certain tax-supported governmental activities, a limit of 30 percent was allowed. The most recent tax reform law increased this latter amount to 50 percent but the limit on certain non-qualifying charities remains at 20 percent. An inquiry to one's favorite charity will reveal its percentage category. Donations to churches, educational institutions, hospitals and certain governmental enterprises are all deductible at 50 percent.

There are two basic ways to make a gift to charity. The preferred method from the standpoint of the charitable organization is an outright donation with no restrictions. The second method is to defer the gift whereby the property is not received until a future time. Giving one's home to a qualified organization reserving the right during life to use and live in it is an example of the latter method.

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There are numerous tax advantages of a present outright gift to charity. There would be no gift taxation whatever. Even though a gift to a charitable organization exceeding $3,000 requires the filing of a gift tax return, there would be no tax payable by the donor. To the extent that such a gift would reduce the one's holdings at death, there would be a savings indirectly in estate taxes. This savings is of special significance to an individual in the higher income bracket. Deductions are allowed on the income tax return to the extent they do not exceed 50 percent of the adjusted gross income. In the event of a large gift, the excess over 50 percent can be "carried over" and deducted on the individual's income tax return for 5 succeeding years, again up to 50 percent per year.

Living in a high tax era with a graduated tax rate which gets progressively higher on higher accumulations, it becomes clear that an actual donation has a net cost which is dollars donated less the dollars saved in taxes. The individual with higher income will find that donations cost comparatively less than a person who is in a smaller income tax bracket.

Methods of making a deferred gift to a charitable institution take many forms. A deferred gift contemplates that some part or all of the gift will be presently retained by a donor for individual personal use until a later date when the charity will acquire whatever remains.

The most common method of making a deferred gift is by means of including a bequest in one's will. A charitable organization is not an heir and if it is to be remembered at death, a will is essential. The value of the gift included in the will reduces the amount of gross estate on which death taxes are assessed. Again if the estate is large enough to be taxable (*i.e.* over $120,000 net for a marital community) the savings in taxes reduce proportionately the cost of the gift.

Gifts in wills sometimes postpone the gift to a charity beyond the date of the maker's death such as when property is left to a surviving spouse for life with the remainder going to the charity upon the spouse's death. In a case like this the value of the remainder interest based upon the surviving spouse's life expectancy represents the amount of gift deduction on the estate tax return.

Life insurance policies are very flexible property items and represent an excellent way of charitable giving. Giving old policies no longer needed for family security will reduce a cash inflow into one's estate at death avoiding extra taxation. Of course, in an estate of lesser value, insurance is one sure method of having liquid assets on hand to pay off debts and the cash inflow may be extremely desirable.

The tax benefits of giving life insurance policies vary. A donation of one's life insurance policy is a gift of its replacement (cash) value. That value is deductible on one's income tax. When one continues to pay premiums on a policy given to a charity, such premiums are deductible on income tax. Naming a charity as a beneficiary is one way to make a gift, but if one still owns the policy and has the right to change the beneficiary to a non-charity, no tax deduction is permited. In giving insurance, the policy itself must be given away beyond the donor's effective power to control it.

In making property donations having an appreciated value, a donation was formerly allowable for the whole value of the donated property. In this way one could avoid tax on its increase in value and get a charitable deduction for the "paper profit." Recent tax reform laws have modified this approach slightly but it is still worth considering even though the tax benefits have been diminished slightly.

The so-called "Bargain Sale" whereby property having an appreciated value was sold to a charity at cost formerly gave a charitable tax deduction for the increased value. This increase was not taxed as income. However, Congress has curtailed these previous benefits.

Corporations are taxed both on corporate profits and the dividend income is taxed again from those receiving it. If a person is the owner of a closely held corporation, it is usually advantageous for the corporation to make gifts the owner might otherwise desire to make before the money goes through two taxing steps. The gift is deductible entirely by the corporation up to 5 percent of its taxable income.

Farmers should consider donating crops to charitable causes. If the crop is produced and sold, an income tax arises on the profit. The usual sales price is a charitable deduction against other income and no income tax results on the profit. Note that the costs of producing the donated crop are not tax deductible.

Philanthropic enterprises are becoming aware of the benefits that can be derived when the public is aware of the tax aspects of charitable giving. These organizations have devised methods of helping those who wish to donate to them on a deferred basis. Charitable and religious organization representatives can explain more fully the benefits of certain donative arrangements such as the gift annuity, life income contract or a life income trust.

The gift annuity operates on the principle that the charity takes the donor's money and returns it at a small fixed monthly rate as long as the donor lives. The rate is low enough that the annuitant can never live long enough to get all of the investment back. In fact one half the investment will find its way into the charity's work. Therefore, an annuity is an income tax deduction for about half of the investment. The income to the annuitant is largely tax free (one's own money is being returned) and only that small percentage portion which represents investment income is taxed to the annuitant. For elderly people the rate of return is higher and this may not be a particularly good method of giving for a young person.

Life income contracts and life income trusts are contractual arrangements whereby property is given to a church or other charity in exchange for a lifetime income. At death the property invested belongs to the charity. The recent tax reform provisions made some new requirements for this type of gift arrangement and the particular tax benefits now available should be fully considered when this investment type is contemplated.

Gifts to charity are completely tax deductible at death on one's estate tax return and no gift tax is ever paid on a gift made during life to a qualified charity. Only on income tax is the deduction for a charitable donation limited. In those instances one may still give generally up to 50 percent of his annual income. The tax-free gift limit on the gift tax return of $30,000 per life and $3,000 per year per donee applies only to gifts made to individuals and never to gifts to qualified charities. Even though a gift over $3,000 requires filing a gift tax return, no tax is payable in such event.

Estate taxes are progressively higher on a graduated basis and the more one owns at death, the greater the estate tax will be. Giving to charity permits an estate of reduced amount to be taxed at a reduced percentage rate.

By giving to charity one takes dollars from his "top" estate tax bracket where they will be most heavily taxed and gets a deduction during life on income tax, in effect a double saving. Giving to charity in some instances does not cost, but it pays. The satisfaction one has from seeing good accomplished in the world through a gift plus saving that which might otherwise be lost, makes intelligent giving to charity worthy of one's most careful attention. Charity still offers excellent benefits to those who would like to avert the heavy impact of death and income taxation.

SUGGESTED READING

Listed below are additional Extension fact sheets on Estate Planning.

L-950 The Importance of a Will in a Texas Estate

L-951 Texas Laws on Descent and Distribution

L-952 Community and Separate Property in Texas

L-954 Charitable Gifts

L-955 Federal Estate and State Inheritance Taxes

L-956 Gifts and Trusts: Effective Estate Planning Tools

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