Charitable giving techniques

Helping achieve your charitable and estate-planning goals

Trust tip

A trust can be thought of as having two parts — an income interest and a remainder interest. The income interest is the right to receive payments from the assets in the trust throughout the trust's term (such as the donor's lifetime or a fixed time period). The remainder interest is the right to the property remaining in the trust when its term is completed.

Giving used to be as simple as writing a check or dropping off old clothes at a charitable organization. But this type of giving, although appropriate for some, simply does not meet the tax-saving or estate-planning needs of many. Fortunately, today's donors can take advantage of gifting strategies that can increase the benefits of their gifts both for the charity and for themselves.

Giving through charitable trusts

One popular method for donating to charity is through a charitable trust. A charitable trust can solve various estate- and income-tax planning problems — all in addition to providing meaningful support to a charity you choose.

With a charitable trust, you can provide either an income or a remainder interest to one or more charities while retaining the other interest for yourself or your beneficiaries.

Two basic types of charitable trusts are commonly used: a charitable remainder trust and a charitable lead trust. These two basic charitable trusts are available in several variations. The trust that best suits you and the charity to which you donate will depend on various factors. As you read about the types of charitable trusts available, keep in mind that before establishing a charitable trust, you should always seek qualified tax and legal advice.

Charitable remainder trusts

A charitable remainder trust lets a donor make a substantial charitable gift now while receiving income from the assets for use during his or her lifetime. The trustee of a charitable remainder trust can sell appreciated property through the trust and obtain a desired level of income for the donor from the proceeds without incurring immediate capital gains taxes. Consequently, more is left to be invested to provide income for the donor and ultimately benefit the charity.

How a charitable remainder trust works

When you donate property to a charity through a remainder trust, you transfer ownership of the property to the trust, which then pays income to you during the trust's term.

You determine the amount of income you will receive based on a percentage (not less than 5%) of the donated property's fair market value. At your death, the death of your beneficiary or the completion of the trust's term, the trustee will distribute the balance of the trust assets to your chosen charity. You may retain the right to change beneficiaries and to name multiple charitable beneficiaries.

Types of charitable remainder trusts

There are two main types of charitable remainder trusts. Their primary difference is how often and in what form distributions are made to income beneficiaries. They also differ in the deduction and number of contributions that can be made to the trust.

Charitable remainder annuity trust. With this type of trust, the income beneficiary is paid a fixed dollar amount each year for life or for a specified term of years (20 years or less) based on a percentage of the original amount contributed to the trust. Once you have made your contribution to the annuity trust, you cannot add to it. Additional contributions, if desired, must be made to a new charitable remainder trust.

When you establish a charitable remainder trust, you are entitled to a current income tax deduction. The amount you can deduct is a percentage of the value of the property placed in the trust. The deduction is calculated using IRS-published tables. The deduction amount depends on your annual payout (generally, the higher your income payout, the lower the deduction), your age and/or the age(s) of your income beneficiary(ies), or the trust's specified term of years as well as the published IRS monthly interest rate. Your tax advisor will determine your deduction.

This table gives examples of charitable deductions assuming a charitable remainder annuity trust is funded with $100,000 and the IRS interest rate is 3%.

Charitable remainder annuity trust ($100,000) deductible values

	Annual payout to donor*		
	5% ($5,000)	6% ($6,000)	7% ($7,000)
Beneficiary age (single)	**Deductible amount**		
60	N/A	N/A	N/A
70	$44,873	N/A	N/A
80	64,567	57,481	$50,394

*Based on quarterly distributions

We've shown several payout levels and beneficiary ages (assuming payments over a single lifetime). For example, suppose you are 70 years old and have a $60,000 adjusted gross income (AGI). You transfer $100,000 in appreciated stock to a charitable remainder annuity trust, which you set up to pay 5% for life (keep in mind that the higher the income payout, the lower the deduction). The stock is paying a 2% dividend. The trustee will probably sell the stock and reinvest the proceeds, and the trust will pay you $5,000 every year until you die. As the table shows, you are entitled to a $44,873 charitable deduction. In addition, you have increased your income from the stock by 3%, the difference between the 2% dividend and the trust's 5% payout.

Because you donated appreciated stock, your deduction is subject to the 30% limitation on charitable deductions. As a result, you will be able to deduct $18,000 in the first year (30% x $60,000 AGI). What you cannot deduct in the first year can be carried forward and deducted within the next five years, subject to the same percentage limitations. (You have a total of six years in which to use up your deductions.) In the second year, assuming the same $60,000 AGI, you would deduct another $18,000, and in the third year, you would deduct the $8,873 balance.

Assuming you're in the 25% tax bracket, your tax savings would be $4,500 ($18,000 x 25%) in the first year. (Other limitations may affect your actual tax savings. Consult your tax advisor.)

Charitable remainder unitrust. A charitable remainder unitrust's payout fluctuates and can provide a hedge against inflation because the annual distributions vary based on the trust assets' value.

You have three payment choices:

- **Standard payment.** This alternative is determined based on at least 5% of the trust's fair market value, which is revalued every year. You (the donor) determine the percentage of trust assets to be paid out at the time your trust is designed.
- **Net-income unitrust.** This payment alternative pays the lesser of your stated percentage or the net income actually earned in the trust.
- **Flip unitrust.** This alternative combines the net-income and standard formats.

Charitable remainder unitrust ($100,000) deductible values

	Annual income payment*		
	5%	6%	7%
Beneficiary age (single)	**Deductible amount**		
60	$38,267	$32,362	$27,593
70	52,478	46,756	41,835
80	67,893	63,222	58,983

*Based on quarterly distributions and an IRS interest rate of 3%

The donor of a unitrust receives similar tax benefits as the donor of an annuity trust. But unlike the annuity trust, additional contributions can be made to a unitrust. The charitable deduction is calculated at the time of each contribution.

- **Standard charitable remainder unitrust.** The deduction for a unitrust is calculated in a similar fashion as an annuity trust (a different set of IRS tables takes into account the fluctuation of the payout). The table on this page shows examples of charitable deductions assuming a unitrust is funded with $100,000 and pays the donor 5%, 6% or 7% of the trust assets' market value.

  Using the same example we used earlier (assuming you are 70 years old with a $60,000 AGI), let's say you transfer $100,000 of appreciated stock to a unitrust that specifies a 5% payment. Because the initial contribution was valued at $100,000, your payout for the first year is $5,000. On Jan. 1 of the second year, let's assume the trust assets are revalued at $105,000, so your payment for that year is $5,250. On Jan. 1 of the third year, the stock market has declined, reducing the trust assets' value to $95,000. Your payment for that year would therefore be $4,750.

You are entitled to a charitable deduction of $52,478 (as the table shows). Again, because you transferred appreciated securities, your deduction is subject to the 30% limitation on charitable deductions. For the year your trust is set up, the deduction would be $18,000 (30% x AGI of $60,000), and assuming your AGI remains the same, you would continue to deduct $18,000 until the third year, when there would be $16,478 left to deduct.

- **Net-income unitrusts.** A net-income unitrust is designed so that the trust will pay out the lesser of the actual trust income or a percentage of the trust assets' value. Such a trust may also include "make up" provisions. This type of trust is sometimes used to accept contributions of illiquid assets (such as real estate) and can also be used by individuals who do not desire additional income now but want to receive it at a later time.
- **Flip unitrusts.** The flip unitrust combines the net-income and standard payout formats. The trust begins as a net-income unitrust until a specified event occurs, at which time the trust "flips" to the standard unitrust payout. The event that triggers the flip cannot be in the control of the donor/trustee. Events such as marriage, divorce, death, birth of a child and reaching age 65 are all permissible triggers. One benefit of this arrangement is that the post-flip payouts will be the stated percentage, regardless of actual income.

Additional charitable remainder trust tax benefits

Estate taxes

In general, when a charitable remainder trust is set up for one's life (and the life of a spouse), all the assets that remain in the trust avoid estate taxes. This may result in substantial tax savings. The estate tax exclusion is $5,340,000 per person in 2014. Therefore, an estate must exceed this exclusion amount before it is subject to federal estate taxes at a 40% flat tax rate.

If a nonspousal beneficiary is to receive income after your death, a portion of the trust assets may not escape estate or gift taxation. For example, if your revocable living trust sets up a charitable remainder trust for the life of your child, the value of the child's income interest will be included when calculating the size of your taxable estate.

Potential to increase income and avoid capital gains taxes

Due to the increased estate tax exclusion, enhancing your potential income and reducing your income taxes have become the more important benefits of a charitable remainder trust.

Many kinds of property, including securities or real estate, can be transferred to a charitable trust. Because the trust is a charitable entity, it will not pay a tax when it sells appreciated property.

As the example below illustrates, if you had sold property and reinvested the proceeds yourself, the amount you could have reinvested would have been reduced by the capital gains taxes you would have paid.

Taxation of trust distributions

The distributions you or your beneficiaries receive from a charitable trust will usually be taxable, depending on the kind of assets you donate and the investments in the trust. The manner in which it is taxed (ordinary income, capital gains, etc.), however, will be determined by a multitiered taxation structure that considers the type of income earned by the trust in both current and prior tax years. Consult your tax advisor for more details on the taxation of trust distributions, what kinds of investments may be made in the trust and how they may affect your circumstances.

Donating versus selling and reinvesting

Suppose you own $100,000 of stock with a $10,000 cost basis. You could sell the stock and reinvest the proceeds at 7%. Or you could transfer it to a charitable remainder trust that specifies a 7% payout. Let's compare these two strategies:*

	Sell and reinvest the proceeds	Transfer to charitable remainder trust
Proceeds/fair market value (Cost basis = $10,000; capital gains = $90,000)	$100,000	$100,000
Capital gains tax ($90,000 × 15%)**	(13,500)	0
Amount reinvested	$86,500	$100,000
	× 7%	× 7%
Annual income at 7%	$6,055	$7,000

*This example is for illustrative purposes only and does not reflect the performance of a specific investment.
** 20% for taxpayers in the 39.6% tax bracket.

As you can see, by using the trust, you would receive $945 ($7,000 – $6,055) more in annual income than if you had sold the stock and reinvested the proceeds yourself.

Charitable lead trusts

With a charitable lead trust, the income interest in the property is distributed to the charity, and your beneficiaries get the remainder interest.

To qualify for favorable tax treatment, a lead trust can be established in one of two forms:

- An annuity format, in which the charity receives a fixed, constant payout
- A unitrust, in which the payout is determined based on a fixed percentage of the trust assets' value, revalued annually

With a charitable lead trust, there are no minimum payout requirements and no specific limitations on the trust's term.

How charitable lead trusts work

A charitable lead trust is often structured to provide gift tax benefits and no current income tax deduction. However, the income from the assets is reported by the trust with an offsetting deduction for the amount paid to charity. (A charitable lead trust can also be structured to provide a current income tax deduction. However, in that case, all future income in the trust will be taxable to the donor each year with no offsetting deductions for distributions to charities.)

A donor can gift more to family members with a reduced gift tax effect because the gift's present value is discounted for the intervening charitable income interest. Of course, the donor must be able to afford to give up both the income interest and the access to principal in the donated property.

For example, if you wish to give $1.5 million to your child, you could set up a charitable lead annuity trust for 20 years and specify a 5% payment per year to a charitable institution. At the end of 20 years, your child would receive the property plus any appreciation and undistributed after-tax income.

When the trust is set up, its value for gift tax purposes would be approximately $384,000 instead of $1.5 million (the value is reduced by the charity's income interest; the calculation uses the same IRS tables as a charitable remainder trust and assumes a 3% Section 7520 rate). Assuming you had not used your applicable gift tax exclusion, you would not have to pay any gift taxes. (The applicable gift tax exclusion lets you transfer up to $5,340,000 during your lifetime without incurring gift taxes in 2014.)

In addition, the appreciation and undistributed income from your gift would not be subject to any gift tax.

Wealth replacement trusts

One disadvantage of a charitable remainder trust is that the assets will not be available for the donor's heirs. This problem can be addressed by using income generated by the charitable remainder trust to create an irrevocable life insurance trust designed to replace the wealth donated to the charity. In some cases, the net assets heirs receive could be greater than they would be if the owner had left the original wealth to the heirs at death because the proceeds from the irrevocable life insurance trust avoid estate taxes. Typically, the donor makes annual exclusion gifts (up to $14,000 per year, per child) to cover the premiums, thus avoiding gift taxes on the premium.

How a wealth replacement trust works with a charitable remainder trust

Suppose you and your spouse transfer $1 million of stock to a charitable remainder annuity trust. The stock is currently paying a 2% dividend. The trustee sells the stock and begins paying you $50,000 per year, according to your trust's terms.

Let's assume you're both 70 years old and can purchase a $1 million life insurance policy for $20,000 per year.* You set up an irrevocable life insurance trust for the benefit of your two children and gift $20,000 each year to the trustee of the life insurance trust, who uses that money to purchase life insurance and pay the annual premiums.

[†]*Estimated premium amount; actual premiums will vary based on your situation.*

Transferring your stock to the charitable remainder annuity trust would increase your investment income from $20,000 (the 2% dividend from your stock) to $50,000 per year. Subtracting the insurance premium ($20,000) and income taxes at 25% ($12,500), your net investment income would be $17,500 per year in addition to providing the wealth replacement benefit to your family.

In addition to the annual income the trust provides, you would also receive a $75,000 tax benefit (based on an approximately $300,000 income tax deduction and a 25% income tax bracket).

With your wealth replacement trust, your heirs will receive $1 million from the life insurance proceeds, while the charity named in your trust receives the balance in the trust. Without the trusts, there would be no charitable donation, and estate taxes would cut the benefit to your heirs almost in half (assuming a 40% rate).

Establishing a charitable remainder trust and a wealth replacement trust can provide the following benefits:

- Low-income-producing assets may be converted to potentially higher-income-producing assets.
- Exposure to highly concentrated equity positions can be reduced.
- The donor may realize income tax savings generated by the charitable tax deduction.
- The donor provides a valuable benefit to a charitable institution.
- The donor's beneficiaries may receive property free from estate taxes and income taxes.
- The donor may avoid immediate capital gains taxes on the transfer of appreciated assets.

If the donor is uninsurable, this "gift replacement" strategy would not be available. If replacing the gift is important to you, be sure to determine insurability before making any irrevocable gift to a charitable remainder trust.

Choosing a trustee or beneficiary

Charitable remainder trusts

You can be trustee of your charitable remainder trust, meaning you can manage the assets in the trust. Keep in mind, however, that you must comply with many IRS rules and regulations as well as file annual tax returns to keep your trust qualified and avoid penalties and taxes.

Alternatively, the charity may be willing to be the trustee. However, you will probably not be free to change your charitable beneficiary or the trustee.

A more attractive choice may be a corporate trustee or a professional trust company. This type of trustee will likely have the expertise necessary to work with your charitable trust and will act independently of the charity. In addition, with a professional trustee, you may retain the right to replace the trustee or change your charitable beneficiary.

Choose your beneficiary to accomplish specific goals. The income beneficiary of a charitable remainder trust can be anyone you choose — including yourself. The trust can be set up for one life, two or more joint lives, or for a specific term (not to exceed 20 years).

You can set up your trust to accomplish a variety of goals. For example, the income can be paid into a trust for the benefit of an incompetent individual. Or you can set up your trust to provide income to an elderly parent whom you support or to an ex-spouse as alimony.

Charitable lead trusts

In general, you have the same choice of trustees as for a charitable remainder trust, but you should always consult your tax advisor for possible limitations in your situation.

Alternatives to charitable trusts

Pooled-income funds

A pooled-income fund is created and maintained by a public charity. As its name implies, the fund consists of assets contributed by many different donors, which are pooled and invested together. All of the donors are paid a proportionate share of the net income earned by the fund. This income depends on the fund's performance and is taxable to you. At the death of each income beneficiary, the charity receives an amount equal to that donor's share in the fund.

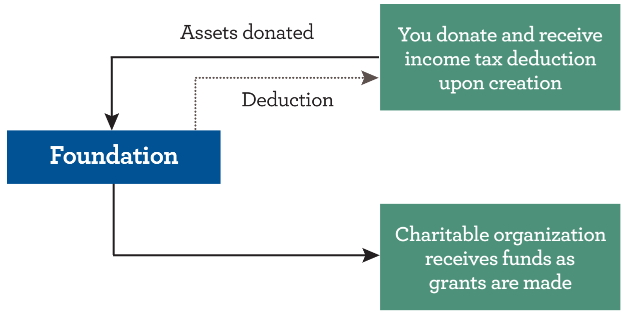
Pooled-income funds share many features of charitable remainder unitrusts, such as protection from capital gains tax on the gift of appreciated property and the ability to make future contributions. But these funds are less flexible than remainder trusts. For instance, you cannot choose your income payout; you will be paid the net income the fund earns. The payout will vary from year to year, depending on what the portfolio generates.

In exchange for lack of flexibility, the pooled-income fund offers simplicity. Rather than having your own trust document drafted, you will be provided with a standard agreement that will let you transfer your assets to the charity. Ask your Financial Advisor about pooled-income funds now available through charitable foundations established by various mutual fund companies.

Charitable foundations

Many individuals and families turn to either private or community charitable foundations as a way to satisfy their philanthropic goals and achieve tax advantages. A private or family foundation lets an individual or family establish its own enduring vehicle for making charitable gifts. This type of foundation or fund often bears the name of the family that creates and funds it.

Charitable foundation



A community foundation provides donors a vehicle for contributing to any of a number of charities benefited by the foundation or specified by the donor through the community foundation's donor-advised funds. These often focus on local causes and organizations.

A private foundation can be structured as a corporation managed by a board of directors or as a trust managed by trustees. Your tax and legal advisors can help you select an appropriate legal structure.

Depending on the type of foundation and the assets you donate, your contributions to a foundation may be 100% deductible. This contrasts with a charitable remainder trust, pooled-income fund or charitable gift annuity, in which you can deduct only a portion of your contribution because you retain an income interest. The donated assets and any income they produce are no longer available to you and your family — the assets must be used exclusively for the charitable foundation's purposes.

Charitable gift funds

Some charitable organizations established by mutual fund companies offer a donor-advised fund similar to those traditional community foundations offer. As with the private foundation, you can make a contribution to the fund today, and then you and your family can decide which charities you want to benefit and when you want to make distributions.

You can combine a charitable foundation or donor-advised fund with other estate-planning alternatives to achieve even greater benefits for you and your beneficiaries. For example, the foundation or donor-advised fund could be the recipient of the balance of a charitable remainder trust that you establish to avoid capital gains taxes on the sale of appreciated assets, or, with proper planning, income from a charitable lead trust could be paid to your charitable foundation or donor-advised fund.

Charitable gift annuities

Like a charitable remainder annuity trust, a charitable gift annuity lets you contribute assets but retain a constant payout from those assets for life.

You can count on us

Determining which charitable strategy best fits your situation can be a challenge. Know that with Wells Fargo Advisors, your Financial Advisor can help you determine the right gifting strategy.

A gift annuity is an agreement in which the charity promises to pay you an income stream in exchange for your charitable gift. A portion of the gifted assets' value (based on the present value of the future benefit) is tax-deductible, and the assets are removed from your estate, avoiding estate taxation after your death. The payment obligation is unsecured and depends on the continued financial health of the charity making the promise.

As with a pooled-income fund, a gift annuity provides less flexibility than a trust. But a gift annuity is simpler than a charitable trust because it requires only an agreement provided by the charity.

Choosing a charitable technique

When choosing a charitable technique, consider that:

- A charitable remainder annuity trust or charitable gift annuity is designed for those who want to give to charity but still desire a fixed income.
- A charitable remainder unitrust or pooled-income fund, in which your payment fluctuates, provides an income that can vary over time.
- A charitable lead trust is best suited for those with sufficient assets to provide for current and potential income needs and whose objective is to provide income to a charity for a time, with a future distribution to family.
- A private foundation or donor-advised fund lets an individual or family obtain a current income tax deduction and establish a long-term vehicle for making charitable gifts.
- Itemized charitable income tax deductions may be limited for high-income taxpayers under the American Taxpayer Relief Act of 2012.

You should seek qualified legal and tax advice before using a charitable technique. Once you've decided on a strategy that may be right for you, consult a professional trust company as needed. Ask your Financial Advisor for additional information on charitable techniques, including your personal charitable trust illustration.