

# Moderate-Income Seniors Can Also Leave a Charitable Legacy

■ Many seniors have conflicting financial and charitable priorities. They may want to make a generous donation to charity, yet also need income to meet their own day-to-day financial obligations. Deferred gifts may be the ideal solution. **BY FRANK VIDIN, CFP, CSA**

Seniors who want to donate money to charity have a wide range of options. They can give cash or assets. They can give immediately, or they can make contributions as part of their estate. Most seniors are aware of these options. However, many seniors are unaware of a less frequently used option: deferred, or planned, gifts. These gifts are more complicated than a simple cash donation, but they have a number of advantages. Not only do they benefit the senior's charity of choice, but they can also provide an income stream for life, even as they may also provide an income tax deduction in the current year.

Qualified financial professionals can greatly assist their clients by explaining how deferred gifts may be able to help them achieve their charitable goals while increasing their income at the same time. (See *How Deferred Gifts Work* on page 61.) Please note, though, that because some of these approaches to giving are complex and require customized legal documents, anyone engaging in them should work closely with qualified attorneys and with representatives of the participating charitable organizations.

## Pooled income funds

You can think of a pooled income fund as a charitable mutual fund. Gifts from multiple donors are pooled into a managed portfolio

of stocks, bonds, and/or other investment vehicles managed by the charity. Often the portfolio is income-oriented. Any interest or dividend earnings paid by the investments in the portfolio are passed on to the donor as an income distribution, usually on a quarterly basis. Once the gift is made, none of the principal can be withdrawn from the pooled income fund. Although a pooled income fund cannot be set up to automatically reinvest its income distributions in fund assets, donors can make additional contributions, so they can manually reinvest distributions if they want.

At the donor's death, his shares are retired from the pooled income fund, and the fund distributes the dollar value of those shares to the charity. In the year that an individual makes a donation to a pooled income fund, he can deduct the value of the gift from his federal income taxes, as long as he itemizes



deductions. A formula is used to determine the value of the gift, taking into consideration current interest rates, the estimated value of distributions, and the donor's age. The charity managing the pooled income fund will calculate the charitable deduction for the donor.

For example, Gerald and Susanne established an account in a pooled income fund with their local community foundation. The portfolio consists primarily of bonds, and each quarter they receive a check from the fund for their portion of the portfolio's interest and dividends for that period. Their quarterly checks vary in size as the portfolio's income varies. Every time a check arrives, Gerald and Susanne have the option to either use the income or to return it to the fund in the form of an additional contribution. If they keep the income, it will be subject to income tax. Alternatively, if they return the income to the fund, the IRS will consider this a charitable gift eligible for a partial income-tax deduction.

Suppose that Gerald dies before Susanne. After his death, Susanne will continue to receive the quarterly distributions. Upon Susanne's death, all the shares donated by Gerald and Susanne will be removed from the fund and made available for the purposes designated by the community foundation.

### Charitable gift annuities

A charitable gift annuity is an agreement between a donor and a charity whereby the donor provides a gift to the charity and, in exchange, the charity agrees to make periodic (typically quarterly) payments to the donor or another beneficiary for life. The agreement establishes the dollar amount of the payments up front; their amount does not vary with investment performance, increase to account for inflation, or change for any other reason.

Charitable gift annuities are regulated by the state in which the charitable organization is located. Some states have complex rules that

these agreements must follow, while other states have no rules at all. Most organizations follow the recommendations of the [American Council on Gift Annuities](#), which suggests payout rates based on actuarial calculations assuming that 50 percent of the amount of the initial donation will be available to the charity at the death of the donor.

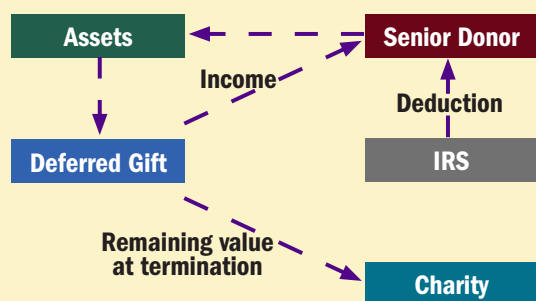
When the agreement is executed, the gift immediately becomes the outright property of the charity. The charity is under no obligation to use it in any particular way or to set it aside. Income payments to the donor are supported by the total assets of the nonprofit organization. In many states, a charity is not required to retain enough assets to ensure that it can make its contracted annuity payments. In fact, several charities that entered into charitable gift annuity agreements subsequently declared bankruptcy, leaving annuitants with no income payments. Therefore, it is important to enter this type of agreement only with charities that have substantial assets.

In the year that the annuity agreement is executed, the donor receives an income tax deduction for the future value of the gift to charity, as calculated by the charity offering the annuity, based on an IRS formula. Most of each periodic payment from the annuity is subject to income tax, but a portion is considered a tax-free return of principal until the entire non-deductible portion of the contribution has been received.

Suppose, for example, that Dwight is looking for a way to simultaneously increase his retirement income, reduce his current-year

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## HOW DEFERRED GIFTS WORK



income taxes, and benefit his alma mater. He and his wife establish a gift annuity with the university. They receive a significant income tax deduction this year, and they begin receiving quarterly checks, which will keep coming until after both have passed away. Because the payments include a return of principal, the checks are higher than what Dwight would earn as interest on a CD or other low-risk investment of the same amount of money, and part of each quarterly check is free from income tax.

### Charitable remainder trusts

A charitable remainder trust is an irrevocable trust that provides income payments to the donor or the persons he or she designates in the trust document. By law, a charitable remainder trust must pay out at least 5 percent each year, and it must exist for either the lifetimes of the income beneficiaries or for a designated term that may not exceed 20 years. Any remaining balance at the end of the term is distributed to the charity named in the trust. All distributions are collateralized by the assets in the trust. Should the trust assets become depleted before the end of the distribution period, distributions will cease.

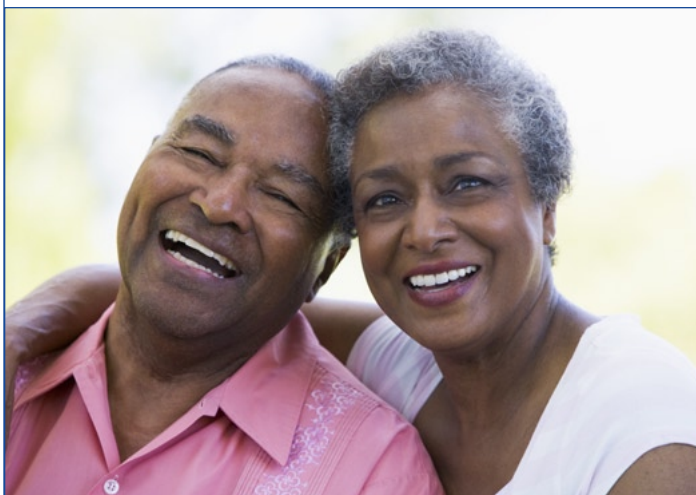
Two types of charitable remainder trust are allowed by law: the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT). Charitable

remainder annuity trusts cannot accept additional contributions after their creation. In addition, because the size of distributions is based on the initial amount placed in the trust, the dollar amount of distributions never changes. Charitable remainder unitrusts may accept additional contributions. The size of their distributions is adjusted annually to reflect changes in the value of the trust assets; each year's distributions are based on the value of the trust assets at the close of the previous year.


The charitable deduction when a donor funds a charitable remainder trust is determined based on prevailing interest rates, the percentage paid out, and the number of years that the payout is expected to last. Most charitable remainder unitrusts begin payments immediately upon funding, and are called standard CRUTs (SCRUTs). However, if the trust is funded with illiquid assets and time is needed to sell those assets before money is available for distribution, a unitrust may be set up as a net income CRUT (NICRUT) or a net income with makeup CRUT (NIMCRUT). A NICRUT begins its standard payments once income becomes available, while a NIMCRUT also includes makeup payments to account for distributions that the trust was unable to pay earlier.

Charitable remainder trusts are complex entities that require customized legal documents. They should be set up only in close consultation with representatives of the charitable organization and attorneys experienced in this type of transaction. Charitable remainder trusts have ongoing issues, including determining who will serve as trustee and how trust assets will be invested.

Consider the situation of Maria, who is not married. As she prepared to retire from the dental lab she owned with a partner, her objectives were to receive retirement income, reduce her taxes on the sale of her portion of the business, and provide a tangible donation



to the dental school that provided most of her customers. She decided that the best way to accomplish all of these objectives was to contribute some of her shares in the business to a charitable remainder unitrust, with herself as the income beneficiary and the dental school as the remainder beneficiary upon her death. In calculating the number of shares to donate to the trust, Maria's accountant attempted to

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generate a current-year tax deduction that would offset the taxable income Maria earned by selling the portion of her shares that she did not donate. The result was that she received a lump sum from the sale

of some of the shares, owed no tax on that income, received a stream of retirement income for the rest of her life, and ultimately gave a very generous gift to the dental school.

### Charitable lead trusts

A charitable lead trust is the reverse of a charitable remainder trust; the charity receives income from the trust for a period of time, and any assets remaining in the trust at the end of that period are distributed to the trust's beneficiaries. Two types of charitable lead trusts are allowed by law: the charitable lead annuity trust (CLAT) and the charitable lead unitrust

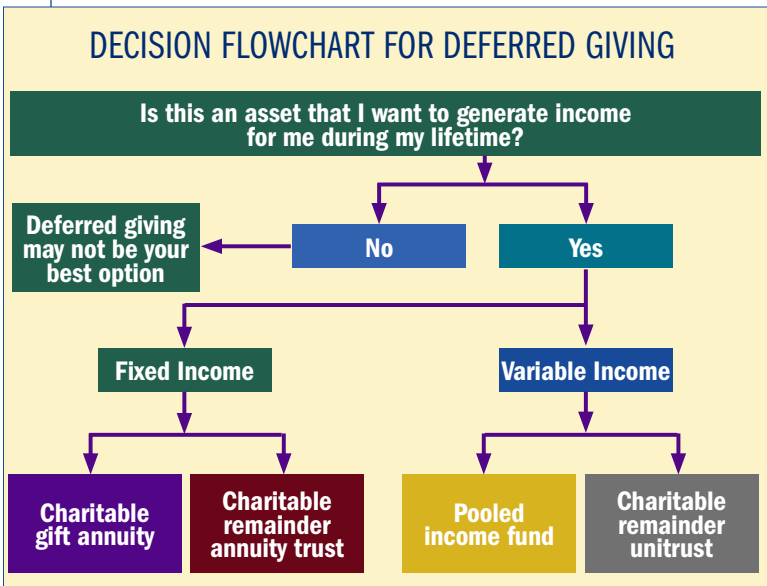
(CLUT). Like CRATs, charitable lead annuity trusts cannot accept additional contributions, and the size of their distributions is based on the initial amount placed into the trust. Like CRUTs, charitable lead unitrusts may accept additional contributions, and the size of their distributions in a given year depends on the value of the trust assets at the close of the previous year. The amount of the charitable deduction is determined based on prevailing interest rates, the percentage of assets that the charity receives in income distributions, and the number of years that the payouts will last.

Charitable lead trusts can help donors support the limited-term needs of a charity, such as funding a project for a few years until permanent funds become available. They are typically used in sophisticated income, gift, and estate tax planning. Therefore, they should be set up only in close consultation with legal and tax advisors experienced in this type of transaction.

For example, when Gil was discussing his sizable estate with his attorney, he said, "I want my children to inherit what I have, but I don't want them to receive it immediately." The attorney asked whether Gil would be open to donating the income on his estate assets to charity while his children waited to receive their inheritance. As a result of this conversation, Gil and his attorney added to his estate plan a charitable lead trust that would distribute income to charity for 10 years following Gil's death, at which point the trust would distribute the remaining balance of the trust's assets to his children. The trust did not reduce Gil's income taxes, but it reduced his potential estate tax and provided generous assistance to charitable organizations.

### Which type of deferred gift is most appropriate?

Because of the variety of deferred gift options that are available, many seniors will need assistance walking through the questions



take a deduction for the gift on her federal income taxes only if she itemizes deductions in the year she enters into the charitable arrangement. State income tax treatment may vary. Deferred gifts can be a great way for seniors to use one financial vehicle to meet an assortment of needs—making charitable donations, taking tax deductions, yet continuing to receive income on the proceeds of the donated funds. ■

and answers that will lead to the appropriate decision for their circumstances. You can use the *Decision Flowchart for Deferred Giving*, above, to help senior clients sort out their needs.

Note that for any of the deferred-giving options, the senior will be able to



**Frank Vidin, CFP®, CSA**, teaches the financial portion of CSA training classes. He is an experienced planned giving officer and financial professional, who also helps nonprofits set up and market planned giving programs. You can reach him at [fvidin@gmail.com](mailto:fvidin@gmail.com) or (360) 887-2168.

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