There are many income and estate tax planning strategies that can be used to optimize the efficiency of your charitable giving. By optimizing, we mean (1) minimizing the cost of the charitable gifts that you plan to make and/or (2) giving more without affecting the legacy that you leave for your family. In other words, you can use these strategies to grow the pie and then divide it however best meets your objectives.

Financial advisors have experience in determining and implementing the investment strategy for a client’s charitable vehicles. Sophisticated planning tools also can help identify

- how much an investor potentially can give,
- optimal assets to use for giving, and
- the probability of success and the potential benefit of using advanced planning vehicles.

To answer the “how much” question, one can use the planning pyramid in figure 1, starting with a “base” to support near-term spending.

Then quantify the “core capital”—the amount of money needed to endow your lifestyle. We use a conservative figure that takes into account poor markets and living a long time.

To the extent that you are fortunate enough to have more money, what we’ll generously call “surplus” capital, that’s the gifting capacity that’s available for either family or philanthropic pursuits.

The Basics
In thinking about assets to gift and vehicles to leverage, let’s consider current income tax rates.

It’s been public policy for quite some time to allow an income tax deduction for charitable donations. In effect, the tax code lets you earmark the tax dollars for the causes that are important to you. In the absence of a charitable gift, you are allowing the government to direct the use of the dollars.

Currently, the top federal tax bracket is 39.6 percent and, with the 3.8-percent net investment income tax, tax rates on short-term capital gains are 43.4 percent and the rate on long-term capital gains is 23.8 percent. Combine that with state and local taxes and the combined tax rate today can be 30–50 percent.

Let’s start with the simplest charitable deduction that most of us are familiar with, the income tax deduction. If we assume a 10-percent state and local tax rate, and that state and local taxes are fully deductible on your federal tax return, a blended rate of 45.6 percent is applied to top-bracket income.

Figure 2 illustrates how the income tax deduction provides leverage to your charitable gifting.

On the top line, you can see the “cash donation.” If you donate one dollar, you get the 46-percent deduction noted above, so the net cost to you is just $0.54. Put another way, if I divided the $1 benefit to charity by the 54 cents it cost me, there is a 2:1 “bang for the buck” in the black box.

If you donate stock, you don’t have to pay the embedded capital gains tax. On the second line, we see that benefit. If you donate a stock that has zero cost basis, then the net cost to you is just $0.54. Put another way, if I divided the $1 benefit to charity by the 54 cents it cost me, there is a 4:1 bang for the buck. If you work for a company that has a corporate match on charitable donations of stock, the bang for the buck grows to 8:1. A double match can bring the ratio to 12:1.
Here are two key rules of thumb to consider: (1) Donate your low-cost-basis stocks and (2) utilize corporate matching dollars. These are pretty simple, straightforward, and powerful levers.

Now, you may be thinking: “This charitable deduction policy is great. I want to earmark my tax dollars to the organizations that are important to me rather than turn those decisions over to Congress.” To protect themselves, however, our lawmakers created limits on how much one can deduct.

If you are making cash gifts to public charities, you can deduct up to 50 percent of your income. However, when donating stock, and/or when you donate to a private foundation (which we will talk more about below), then you might be limited to only 20–30 percent of your income.

Therefore, if you want to make a large charitable gift, or if you are retired and your income is lower, you might not be able to take full advantage of the deductions we just discussed.

Fortunately, some strategies can help you match the timing of your charitable gift with these Internal Revenue Service limits.

Private Foundations and Donor-Advised Funds
By creating a private foundation or contributing to a donor-advised fund (DAF), you may be able to accelerate the tax deduction. If you have a high tax year due to the sale of a low-cost-basis business or real estate, or maybe stock option exercises, you could create a charitable fund in that year and deduct up to 50 percent of your income if you are eligible.

Thus, you could accelerate the timing of the deduction, take advantage of the ability to offset low-basis assets on which you otherwise would owe capital gains tax, and may be able to take full advantage of a charitable deduction that would get phased out in future lower-income years because of the deduction limitations.

Private foundations and donor-advised funds are pretty similar, but they do have some important differences in control, complexity, and disclosure (see figure 3).

In funding a private foundation, the donor has made an irrevocable charitable gift but maintains control of how and when the funds are distributed. This can be particularly important if the donor is creating a personal charitable vehicle such as a scholarship fund or supporting an organization with direct community involvement. In addition, a private foundation can be a way to get and build a legacy of philanthropy by engaging family members in a foundation’s mission and through foundation board meetings. But, with this control comes some strings. The government requires a tax filing to ensure that you gift at least 5 percent of assets a year and pay 1–2-percent excise tax on net investment income. In addition, all activities are publicly disclosed.

In the case of a donor-advised fund (DAF), you get the same benefits noted above, but the execution is simpler and confidential. To the extent that your charitable giving is to established 501(c)(3) organizations, you would “recommend” a gift from the fund...
and the fund will make the gift on your behalf after verifying that it’s a legitimate organization. More and more, we are seeing clients use DAFs because of the simplicity.

Also note that except for the small excise tax in the private foundation, money in these vehicles grows tax-free. Thus, the earlier you place money in the vehicle, the more charitable impact you can create.

Now, let’s look at two more-advanced charitable-giving strategies.

**CRTs and CLTs**

**Charitable Remainder Trust**

The charitable remainder trust (CRT) strategy may make sense if you have a large holding of low-basis stock that you want to diversify today, defer the capital gain taxes, get an annual income, and donate part of it to charity (see figure 4). With tax rates now higher on capital gains, this strategy can make a lot of sense for some investors.

A CRT enables donors to contribute assets to a trust. The trust will last for a set number of years or for their lifetime. At the conclusion of the trust term, the remaining assets go to charity. Donors can choose one or more charities to receive the charitable benefits but also may retain the option to change their minds later. The charity selected may be a public charity, such as an educational institution or house of worship, a donor-advised fund, or a family foundation.

The CRT may pay a fixed amount or a fixed percentage equal to at least 5 percent but not more than 50 percent of the initial fair market value to the income beneficiary(ies). A fixed amount is called an annuity amount (charitable remainder annuity trust or CRAT). A fixed percentage is called a unitrust amount (charitable remainder unitrust or CRUT).

Unitrusts are more common because they tend to align the interest of both the income and remainder beneficiaries. As the trust assets grow, so do the income distributions. Figure 4 provides an example. Let’s suppose a 60-year-old couple has $1 million of low-basis stock. They could put that stock into a CRUT, sell it, and re-invest into a well-diversified portfolio, attempting to reduce their idiosyncratic risk. They can set up the trust such that they would get an annual income for life of 9 percent of the value (revalued annually). This would amount to $90,000 in the first year. They also would get an immediate $107,000 tax deduction.

Even better, the donors only pay capital gains taxes on the sale of the stock as they receive income distributions so the tax is deferred for many years. This tax deferral is so beneficial that should the client live past the life expectancy, the donors may end up better off from a purely personal wealth standpoint.

A unitrust may invest primarily in equities because historically higher growth has created both a higher annual income payout and a higher remainder. In the case of an annuity trust, the income beneficiary might prefer a more bond-oriented approach in an effort to provide certainty that the annual payment is made, but this might not provide much growth for the remainder beneficiary. The payout rate and term also will factor into the optimal asset allocation, including whether taxable or municipal bonds are used. Taxable bonds typically are preferred when the goal is to maximize the charitable remainder. But because of the nature of the four-tier taxation of the payouts, municipal bonds may be preferable to try to maximize the payout to the income beneficiaries. This will be highly dependent on your assumptions for bond returns.

To assess the probability that an investor will meet their objectives, we’ll evaluate 5,000 plausible future scenarios using a Monte Carlo simulation. This statistical technique calculates a range of outcomes based on both the clients’ future spending needs and assumed market returns. As you can see in table 1, after running a Monte Carlo simulation for an assumed initial trust value of $10 million with a 20-year term, taxable bonds support a higher charitable remainder in the median case with an ending value of $11.8 million versus $11.1 million. On the other hand, municipal bonds provide a higher after-tax cumulative payout to the income beneficiaries ($7.7 million versus $7.5 million).

What’s the drawback? It’s an irrevocable gift. So if you get hit by a truck tomorrow,
the whole amount goes to charity. It's a bit like buying a lifetime annuity in that sense. And, while it benefits from today’s high tax rates, the charitable deduction amount would be lower in today’s low-interest-rate environment. CRATs are far more sensitive to interest rates than CRTs, however, because a CRAT’s payout rate remains fixed relative to the assumed return on the trust’s assets.

For clients with charitable intent plus low-basis stock that you seek to diversify, consider a CRT.

Charitable Lead Trust
A charitable lead trust (CLT) can be a great vehicle for someone with both estate-planning and philanthropic objectives. In effect, you can take the charitable giving that you are doing today and get an estate-tax kicker (see figure 5).

The CLT is a mirror image of a CRT. In this case, the income stream goes to charity and the remainder can be paid to the donor’s children or other noncharitable beneficiaries. And, like a CRT, the payments can be either a fixed amount or a fixed percentage of the trust assets. In this case, fixed annuity payments using a charitable lead annuity trust (CLAT) are more common than fixed percentage payments using charitable lead unitrusts (CLUTs).

Let’s suppose you give $50,000 a year to charity and plan to do that for the next 20 years. That would be $1 million in gifts over time (20 years times $50,000 = $1 million).

With a CLAT, you front-load the gift into a trust at a cost of $802,000 (the amount required is based on the Section 7520 rate, which is 2.2 percent as of September 2015) and then the trust makes the $50,000 gifts for you. Any money left over at the end of 20 years goes to your kids free of gift and estate taxes. You can see in this example that with a modest investment return of 6 percent, $733,000 would be left over—about 90 percent of the money that was placed in the trust. By using this vehicle you could do significantly more for your charitable giving without necessarily affecting the legacy to your family.

Table 1: CRUT Taxable vs. Municipal Bonds, Initial Value = $10 million

<table>
<thead>
<tr>
<th>Term: 20 Years</th>
<th>After-Tax Cumulative Payout</th>
<th>Charitable Remainder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable bonds</td>
<td>$7.5 million</td>
<td>$11.8 million</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>$7.7 million</td>
<td>$11.1 million</td>
</tr>
</tbody>
</table>

Note: Values above are for the median outcome of a 70-percent global equity and 30-percent bond portfolio. Tax rates assume federal rates of 39.6 percent on ordinary income and 20 percent on dividends and long-term capital gains, as well as an assumed state income tax rate of 10 percent. Assumes $1 million cost basis on assets transferred to trust. Results are based on a CRUT with a 5-percent payout. Please see notes on wealth strategy analyses below.

This analysis applies to a “grantor” charitable lead annuity trust that is “zeroed out,” meaning that the present value of the future charitable contributions for IRS purposes is equal to the initial funding amount. Based on a 20-year term for the trust and a 2.2-percent 7520 rate as of September 2015 and assumes payouts occur at year-end. Remainder for children is based on a calculation of the future value of the expected remainder. These calculations are performed for informational purposes only.

Tax and Legal Implications: Capital Group Private Client Services does not provide tax or legal advice to its clients. Investors should consult with their own tax and legal advisors regarding any potential investment strategy presented in these materials. This is a hypothetical illustration and does not reflect the investment results of any specific portfolio nor does it guarantee any future results.

Table 2 shows another Monte Carlo simulation. A donor creates a zeroed-out CLAT with a 20-year term and funds it with $10 million. The median value left to the remainder beneficiaries is higher for a stock-heavy portfolio of 80/20 versus a balanced portfolio of 60/40. But, the probability of having a value at the end of the term left to the beneficiaries in the first place improves from 85–90 percent to 90–95 percent with a more balanced mix. Thus, consider adding more fixed income to the mix as the trust term shortens.

Conclusion
As financial advisors, we are well-positioned to help our clients achieve their charitable and legacy goals. The more we learn about their objectives, the more we may be able to help identify value-added strategies by donating the right asset to the right vehicle, and investing the assets in such a way that will optimize the philanthropic impact.

Michelle J. Black, CIMA®, CPWA®, is a senior vice president and head of the wealth advisory group for Capital Group Private Client Services. She earned a BS in business administration from the University of Southern California and holds a professional designation in personal financial planning from the University of California, Los Angeles. Contact her at mjblack@capgroup.com.
Endnotes

1. The present value of the charitable remainder interest of the trust must be at least 10 percent of the initial fair market value which could further limit the payout depending on the 7520 rate.

2. CRT distributions have a four-tier taxation to the income beneficiary; ordinary income (taxable interest and dividends), capital gains (short- and long-term including embedded gains), tax-exempt income, and principal. In each tier, the current year is paid out first, then any undistributed amounts from prior years. Each tier must be fully paid out up through the current year before the next tier is deemed to be distributed.

The purpose of this article is not to provide tax or legal advice. Investors should consult with their own tax and legal advisors regarding any potential investment strategy presented in these materials.

The views expressed herein are those of the authors and don’t necessarily reflect the views of everyone at Capital Group Private Client Services. The thoughts expressed herein are current as of the publication date, are based upon sources believed to be reliable, are subject to change at any time, and should not be construed as advice. There’s no guarantee that any projection, forecast, or opinion in this paper will be realized. Past results are not a guarantee of future results.

Notes on wealth strategy analyses: Stocks are represented by global equity and bonds by either U.S. municipal bonds or U.S. taxable investment-grade bonds as noted. The calculation takes into account federal taxes at the top marginal rate of actual returns. They reflect our projections of long-term asset-class returns and are based on the respective benchmark indexes (MSCI World for global equity, Barclays 1-10 Year Municipal Index for municipal bonds, and the Barclays Aggregate for taxable bonds), and therefore don’t include any outperformance gain or loss that may result from active portfolio management. All market forecasts are subject to a wide margin of error, including those modeled here. Note that the actual results will be affected by the management of the investments and any adjustments to the mix of asset classes.

Table 2: Trade-offs of Investing CLATs with Different Allocations

<table>
<thead>
<tr>
<th>Allocation</th>
<th>Probability of ending value &gt; $0</th>
<th>Remainder value</th>
</tr>
</thead>
<tbody>
<tr>
<td>80/20 Allocation</td>
<td>85–90%</td>
<td>$9.4 million</td>
</tr>
<tr>
<td>60/40 Allocation</td>
<td>90–95%</td>
<td>$7.3 million</td>
</tr>
</tbody>
</table>

Note: Median remainder value. In the 80/20 allocation, the trust is allocation 80 percent to global equities and 20 percent to U.S. taxable bonds. In the 60/40 allocation, the trust is allocated 60 percent to global equities and 40 percent to U.S. taxable bonds. Assumes that charitable payout fully offsets taxable income. Please see notes on wealth strategy analyses below.