Its own reward

It's true that the tax benefits of philanthropy aren't what they used to be. But charitable giving continues to offer profound gains for high-net-worth individuals

by Charles A. Lowenhaupt

Do gifts to charity still make tax sense? It's a highly pertinent question these days. With income tax rates down, capital gains tax rates down and estate and gift tax rates down (and possibly disappearing), the after-tax cost of a gift to charity is up.

Those of us over age 50 can attest that once upon a time capital gains rates were 40%, income tax rates were 70% and estate tax rates were 70%. In those good old days, a gift to charity could cost less than nine cents on the dollar. Today your accountants can evaluate your situation to construct pro forma computations that, with limitations, alternative taxes and state taxes rolled in, can sometimes show the after-tax cost of a charitable gift to be in the neighborhood of 80 cents on every dollar.

Consider the charitable remainder trust. The owner of an investment asset can give it to a trust from which he or she receives the income or some portion thereof for a term, or for his life or the life of another, with the remainder passing to charity. The trust can sell the asset with no capital gains tax, and the donor receives income tax deduction and owes a gift (or estate) tax only on the value of any income interest following his own (determined actuarially).

Assume you have capital gains property worth $100 in which you have no tax basis. You want to provide for charity but retain a stream of income from the property. You contribute it to a charitable remainder trust and retain an income interest in the trust. When capital gains rates are 40%, and assuming the trust immediately sells the stock, you and your family would enjoy the income from the full $100 instead of the income from just $60, the after-tax proceeds had you sold the stock without using such a trust.

Also, when regular income tax rates are high, your deduction on creation of the charitable remainder trust is more valuable; when gift and estate tax rates are high, the reduction of gift tax can be a nice benefit, and loss of principal resulting from the gift is more palatable.

But when capital gains rates are only 15% (if you live in Nevada, Florida or another income tax haven), that trust loses a lot of its tax clout. It might make more sense to forgo the gift altogether, pay 15% on the sale of the stock and keep 85% of the proceeds to leave to your children, possibly at no estate tax.

A charitable lead trust is an upside-down charitable remainder trust. An annuity or percentage (e.g., 6%) of trust principal is paid annually to charity, and, at the end of a term of years, the trust is distributed to private persons, usually the donor's children or grandchildren. The trust is complex and generally without income tax deduction. But the concept is that the gift tax value of that remainder to be distributed to children or grandchildren is computed using Internal Revenue Service assumed rates lower than the trust actually produces, so that the children receive much more than the donor paid in gift taxes.

One of our clients in 1981—before he had to worry about the generation-skipping transfer tax—contributed $2 million to a trust to pay $130,000 per year to charity for 30 years, at which time the trust is paid to his grandchildren. His gift tax was based on roughly $100,000 of gift (computed as $2 million less the value of $130,000 per year, assuming interest rates of 6%). Today, after paying the annuity each year to charity, that trust is worth $70 million, all of which will pass to the donor's grandchildren in 2011. The family will have saved $35 million in estate taxes alone if those taxes are 50% and values remain as they are now until the trust terminates.

But the family will have saved nothing in taxes if there is no estate tax imposed when the donor dies. And the $130,000 paid to charity each year will have been a "tax waste."

Should charitable giving, then, be abandoned? Are taxes the only reason to engage in philanthropy? In what ways can you look at philanthropy's role in wealth management?

Consider a client of ours who was a curmudgeon when it came to charities. He set up a charitable lead trust only upon being shown that, after taxes, his family would inherit more if he used the trust than if he did not. But he and his family soon realized great satisfaction and pleasure in their annual direction of the annuity among charities—and today his widow and children are major philanthropic forces in their communities, well beyond what the trust pays.

Philanthropy gives value to wealth. If the wealth holder computes what is needed for support, for education of children, for luxuries as extravagant as desired and for contingencies of market action or personal circumstance, he or she may well conclude there is more wealth than is "needed" and might reasonably look beyond consumption.

If the wealth holder asks what the wealth is for, he or she might reasonably conclude it is to create functionality and the ability to pursue happiness for his or her children. Then the question is how he or she can send constructive messages to those children about the use of wealth in a satisfied life.

Philanthropy shows wealth can be valuable even when not used for personal consumption. It shows wealth can be used to benefit others, to play a role in one's world and to connect to a community. The parent engaged in charitable giving—whether through gifts or volunteerism—is a model to his or her children of how wealth can be used maturely and with satisfaction.

Many families design foundations and programs to use charitable giving to build functionality into the family through shared experiences and common efforts to build culture and values. Tax savings may minimize the cost of such programs—but family love is the motivation for them.

Families can set up foundations with narrow purposes developed after intensive collaboration. They can design foundations with multiple funds to allow different members to address their own interests creatively. The shared experiences of using family resources to benefit others create bonds of value and culture and determination.

Families can also engage in philanthropy without technically designed structure. Consider the family that devotes each Thanksgiving to serving food and doing laundry in the pediatric hospital where it lost a child to cancer one Thanksgiving years ago. That family builds value in its wealth as surely as if it had a professionally administered foundation.

So it's reasonable to conclude charitable giving is fundamental to wise wealth management. Proving that wealth has a worthwhile purpose, sharing values with children and grandchildren, connecting to one's community are reasons enough for philanthropy.

An astute wealth holder can use whatever tax benefits are offered to make charitable gifts cheaper—but will not allow the reduction of those benefits to inhibit the wise use of wealth. n

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