

Coping with Wrenches in the Charitable Giving Toolbox

by Jim Grote, CFP

Three years ago in the *Journal of Financial Planning* (“The Charitable Giving Toolbox,” [October 2000](#)), planners reported that the rapid increase in their clients’ wealth was changing the charitable landscape. Business was booming and the charitable giving toolbox available to advisors was growing ever more sophisticated.

How times have changed. While the tools are still around (from CRTs and CLTs to PIFs and even NIMCRUTs), the slowdown in the economy has thrown a monkey wrench into the demand for such advice. “The last three years have changed the charitable attitude of clients,” says Chuck Jones, CFP, of The H Group in Portland, Oregon. He sees clients cutting back on their giving and even eliminating charities from their philanthropic list, although he notes that church giving is hanging tough. The sad irony for Jones is, “When the economy is down, charities need the money more than ever.”

Changes in the tax code in the last several years have not helped the situation. For example, with the decrease in the capital gains rate from 28 percent to 20 percent and now to 15 percent in the new tax package, vehicles such as the charitable remainder trust become less attractive from a purely economic perspective. The increased exemption equivalent for estate tax purposes (currently at \$1 million and headed toward \$3.5 million) makes estate tax savings less of a motivating factor in establishing charitable bequests and trusts. As Mark Pash, CFP, a planner with Pash and Benson in Encino, California, dryly notes, “The estate-tax-exemption equivalent always seems to rise to meet the average net worth of members of Congress.”

In addition to the economic downturn and changes in the tax code, charitable giving has also been plagued by negative reactions to the charitable management of donor funds following the September 11 terrorist attacks on the United States. The Association of Fund Raising Professionals’ 2002 report states, “Public confidence in the charitable sector, though still high when compared with the for-profit sector, has never been as low.” (For a full copy of the report, go to www.afpnet.org).

Grizzly Bears and Teddy Bears

When compared with the for-profit sector, the charitable sector has weathered the economic storm a bit better. In the aftermath of 9/11, corporate scandals and the collapse of the bull market, the last three years have been a grizzly bear market for the financial sector. While up 21 percent in the last year of the bull market (1999), the S&P 500 Index was down 9 percent in 2000, 12 percent in 2001 and 22 percent in 2002. The bleeding may finally have stopped in 2003, with a year-to-date positive return of ten percent as of May 31, 2003.

Charitable giving has suffered, but not to the same extent. Giving totaled \$199 billion in 1999, \$211 billion in 2000, \$238 billion in 2001 and \$241 billion in 2002 (see *Giving USA 2002*, published by the AAFRC Trust for Philanthropy, at www.aafr.org). Giving in 2002 showed a –0.5 percent decline from the previous year when adjusted for inflation. Charitable giving is going through what can only be described as a teddy bear market in comparison with the financial markets. According to Leo Arnoult, chair of the AAFRC Trust for Philanthropy (which has been publishing charitable giving statistics since 1955), “Historically, charitable giving does not go down during recessions, but the rate of growth drops.”

The mild decrease does not infer that charitable-giving planners are not feeling the pain. Far from it. Almost every planner interviewed by the *Journal of Financial Planning* reported a significant decrease in the charitable planning side of his or her business. Part of this gloom may be due to market segmentation in the charitable giving world. Donations from merely “affluent” donors appear to be harder hit than donations from mega-donors and from mini-donors.

Jeffrey Daniher, CFP, observes, “When the market turned sour, we saw client giving continue at previous levels for a while, but in the second and third year of the bear market, their giving slacked off.” Daniher, a founder of Ritter Daniher Financial Advisors LLC in Cincinnati, Ohio, has \$32 million under management and actively promotes philanthropy. Twenty percent of his 55 full-time clients (with a net worth ranging anywhere from \$500,000 to \$5 million) have some type of active charitable strategy in place. During the bull market, his clients paid less attention to the amount of their giving relative to their portfolio. Tough times have forced a stricter scrutiny. Stephen Hample, CFP, of Financial Planning Associates in Bozeman, Montana, notices an even sharper decline. “I see large donations (\$10,000 and more) in our part of the country drying up. These gifts are often being replaced with annual gifts of \$1,000.”

Suzette Rutherford, CFP, J.D., working for a Naples, Florida, firm that does substantial charitable planning, experiences the bear market differently. With \$1.5 billion under management, Clarfeld Financial Advisors’ 200-plus clients have an average net worth of \$20 million. Rutherford has not seen the philanthropic attitude of her clients change much. “When you’re dealing with very high net worth people, you must realize that these people (aside from a few high rollers) don’t play the races anymore. They go for consistent returns and have generally not suffered as much in losses as other people in the current bear market. Plus, they don’t feel their losses as deeply. So their giving continues.”

Foundations and Donor-Advised Funds

However, one should not conclude that charitable giving is only for the upper echelon. Recent trends in charitable giving seek to provide sophisticated services to middle-income clients. The price of establishing a charitable foundation used to be prohibitive. With initial set-up charges running from \$20,000 to \$30,000, along with costly administrative overhead, donors usually started private foundations only when they were willing to contribute \$1 million and up.

Turnkey operations are one new alternative to costly foundations, lowering start-up costs to \$5,000 and contribution minimums to \$100,000. These companies take care of administration and compliance issues while allowing advisors to manage their clients’ foundation assets. One turnkey operation for example, promises to deliver a foundation in just 3 business days after a 15-minute information gathering process with the client and advisor.

A more traditional option to private foundations that continues to gain popularity (even during the bear market) is the donor-advised fund, which some planners nickname the “poor man’s foundation.” “Donor-advised funds offer a consolidated vehicle to really help your clients get a handle on their charitable giving,” says Daniher. Many of his clients feel guilty turning down charitable solicitors. “But the donor-advised fund provides a way for them to insulate themselves from the feeling that they have to give to every single cause that comes down the pike.”

These funds allow donors to give cash, stock or other assets to special accounts, claim a tax deduction in the year of the gift, and then recommend how and when the money in the fund should be given to charity. Community foundations and Jewish federations have offered such opportunities for decades. Funds established by commercial entities (referred to hereafter as commercial funds) began proliferating after Fidelity launched the first commercial donor-advised fund in 1992.

A report in the May 15 issue of the *Chronicle of Philanthropy* (<http://philanthropy.com>) charts the recent performance of 12 commercial funds as well as 70 funds held in community foundations and other nonprofit organizations. Total assets for these 82 funds fell 2.2 percent in 2002 compared with 2001. Furthermore, many of these funds saw a decline in contributions, though many funds added over 2,000 new accounts in 2002.

One worry that clients often express about donor-advised funds is the word “advised.” Technically, the sponsoring agency (commercial or nonprofit) has the final say about where the money goes. Still, as a rule, donor wishes prevail. Skip Schweiss is vice president of DATAlynx, a firm in Denver, Colorado, offering custodial services and back-office support to financial advisors. He remarks, “Unless it’s a donation to al Qaeda, the donor’s wishes are almost always followed.” For Schweiss, donor-advised funds offer a convenient alternative to private foundations because they can be established with lower minimums (in the \$10,000 to \$25,000 range) and require much less ongoing administration. And, of course, planners may share in the fees of commercial funds.

Daniher prefers setting up his clients’ donor-advised funds through his local community foundation. “Eaton Vance’s fund has internal expenses of almost three percent, roughly one percent for administration, one percent for the advisor and one percent for the mutual fund company. While I would personally get one percent using Eaton Vance, I wouldn’t be providing the best service for my clients.” By contrast, community foundations can run money for around 1 percent, cheaper than many, but not all, commercial funds (for example, fees at one commercial fund run between .65 and .75 percent for a \$100,000 account). Fees and other information on 25 prominent commercial funds can be found in Jennifer Nelson’s article in the June 2003 issue of *Bloomberg Wealth Manager*.

Community Foundation Advantages

While community foundations do not offer advisors the potential fees associated with commercial funds, they do offer a couple distinct advantages of which planners need to be aware. According to Kathy Steward, CFP, vice president for fund development at the Community Foundation of Louisville, in Louisville, Kentucky, first, community foundations are designed to provide more service and hand holding than commercial funds. Foundations work closely with donors in the grant-making process (such as providing extensive information on the charities under consideration, if desired). Second, more complex gifts are easier to make with a community foundation (such as closely held stock or real estate). Says Steward, “These gifts are labor intensive and community foundations are set up to provide this support.”

Daniher echoes this service theme. “I like to use community foundations because they offer free advice and free technical gift proposals to planners. Plus, I feel like I’m giving back to my community in some small fashion. Working with community foundations is a part of my charitable giving.” Stephen Hample, in Montana, was so sold on the idea of community foundations that he started one himself. Four years ago, he put together a volunteer board and created the first community foundation in Bozeman.

Not that community foundations are a panacea for charities in the current market. Steward sees a significant drop in donations in her part of the country. But while gifts of stock have followed the decline in appreciated assets (at least publicly held assets), she sees *more* gifts of real estate and more interest in gifts of limited partnerships. And she is doing more long-term charitable planning for clients. “They are giving through their estate plans instead of their current funds, a popular method being a donor-advised fund created at the donor’s death.”

Even in the midst of an ugly market, Schweiss at DATAlynx has an increasing number of advisors contacting him about the potential in charitable giving. “They may be hurting for business and searching for new opportunities, or simply looking to provide additional services for existing clients.” Yet, despite the uptick in interest, Schweiss remains surprised at the general reluctance of planners to delve into charitable giving. “Most planners get a ‘deer-in-the-headlights’ look when we try to interest them in charitable vehicles. They want to keep their practice simple and just manage money. The complexity of charitable vehicles is often very intimidating.”

Trust Vehicles: A Cornucopia of Acronyms

Still, several of the planners we interviewed had experience in charitable trusts, the two prominent “split-interest”

vehicles being the charitable lead trust (CLT) and the charitable remainder trust (CRT). With CLTs the income stream goes to charity and the remainder interest to a noncharitable beneficiary. With CRTs, the income stream goes to the donor or some other noncharitable recipient, while the remainder interest goes to one or more charities. While CRTs are popular income tax planning vehicles for the typical affluent client, CLTs remain important estate and gift tax planning tools for the mega-affluent.

CLTs tend to have an esoteric aura, at least in the Midwest, where Daniher jokes, "I'm hearing a lot about charitable lead trusts today, but I'm not seeing as many of them done. Of course, this may be because I live in Cincinnati. Mark Twain once remarked that if the world ever ended, he wanted to be living in Cincinnati because everything happens there 20 years later!"

Down in Florida it's a different story. Suzzette Rutherford is making productive use of CLTs with her high net worth clients. CLATs, or charitable lead annuity trusts (which pay out a fixed annual amount to charity), are an especially good strategy because of current low interest rates. She finds three applications particularly useful.

First, for clients wanting to pass money to their grandchildren, the CLAT is ideal. The income stream benefits charity for a number of years before the corpus goes to the (presumably matured) grandchildren. The grandparents effectively freeze the value of the trust assets because the relatively small gift tax they pay is based on the present value of their future gift. This value is calculated using the applicable federal interest rate that is based on conservative government bond rates in a current environment where interest rates are at historic lows. So present values are lower than ever. The appreciation in the trust grows estate-tax-free, although the beneficiaries do not receive a step-up in basis when they inherit these assets.

Second, Rutherford finds CLATs useful for high net worth clients who have already exceeded their adjusted gross income amount for charitable tax deduction purposes. "Say they want to give out another \$40,000 a year, but cannot deduct it," says Rutherford. "They can put \$1 million in a CLAT (which places the money outside their taxable estate) and pay the charity \$40,000 a year from this trust. They don't recognize this \$40,000 as additional income, so it has the same effect as a \$40,000 tax deduction."

Third, as director of Elder Care Services for her firm, Rutherford sees one other application of the CLAT for younger retirees who are in poor health but still have a significant life expectancy. If the client dies prematurely, the remainder interest goes to the beneficiary earlier than expected and the client has not given as much to charity. But Rutherford warns, "This technique has been abused in the past so there are certain thresholds for how long a person must live after setting up this trust. Advisors have the burden of proof that the client was not terminally ill when the trust was initiated."

Charitable remainder trusts have always been more common among planners, but their popularity is waning. Mark Pash, who put together his first CRT for a client in 1980, says the CRT business is down today because appreciated assets are much scarcer and tax changes have made this technique less attractive. In his practice he sees 1031 exchanges (like-kind exchanges of property held for productive use in a trade or business) replacing CRTs to deal with the tax problems involved in highly appreciated business property.

Likewise, in the past bull market, Don Scholz, CFP, did a thriving business in CRTs. Scholz, a planner with Marshall Financial Group in Doylestown, Pennsylvania, found them to be an ideal tool for corporate executives over-weighted in highly appreciated company stock with a need to diversify their portfolios. In the 1990s, this appreciation came from options, stock purchase plans and even outright stock grants from the employer. Incentive stock options (ISOs) were particularly popular in setting up CRTs because the client had to hold the stock for a year in order to receive long-term capital gain treatment.

Today, of course, it's a different story, although Scholz remains hopeful. "If the market continues to improve in

the future as it has recently, we hope to see interest in these trusts return.” For his corporate executives, the CRT provides (1) a tax deduction up front (for the present value of the remainder interest to charity) and (2) a way to diversify their portfolio without paying capital gains tax and still provide a potential income stream down the road. By using a NIMCRUT (a charitable remainder trust with net income make-up provisions), executives can defer the income from the trust to a later period, turning the CRT into a convenient retirement plan. But with the market down, as Scholz laments, “we don’t see a lot of low-basis stock lying around.”

Rutherford paints a rosier picture. “We still see a good market in CRTs. Everyone should consider the CRT strategy for clients with low-basis stock. Even if the result (compared with selling the stock outright and paying the taxes) is a wash in the long run, with the CRT you still have the added value of charitable giving. It’s the icing on the cake.”

So where’s the low-basis stock? It’s in two special niches, according to Rutherford: old stock that clients have held for decades and privately held stock in companies that have done well throughout the bear market. One of her clients is a single woman who bought \$3,000 worth of General Electric and Bristol Meyers in the early 1950s. The stock is now worth \$1 million. Her client has reached retirement age and is not worried about beneficiaries. “Instead of selling the stock and paying the tax up front and substantially reducing her portfolio, we put all the stock in a CRT. Because of her age, we can take out an annual income of 20 percent of assets, which has tremendously increased her retirement income.”

Another client of Rutherford’s, a man in his seventies, just funded a CRT with low-basis privately held stock. “When the managers in the company offered to buy back his stock, we told him he could sell it and pay capital gains tax or put it in a CRT. He chose the latter and has increased his retirement income as well as having payments continue to his two children after his death.” (Of course, planners need to pay close attention to the Internal Revenue Service rules concerning pre-arranged sales.)

Other Vehicles of the KISS Variety

As the old cliché goes, “when the going gets tough, the tough get going.” In a tough charitable giving environment, the adage might better read, “when the going gets tough, the tough keep it simple.” There are a couple of alternatives to trusts in the current low interest rate environment that perform well and are quite simple to execute.

Charitable gift annuities provide a simpler alternative to charitable remainder trusts. No need for lawyers, trust documents or trust tax returns. Hample has several clients who have established charitable gift annuities. As he says, “The gift annuity is a great tool for charitable giving because it doesn’t require a trust document. While I’m very conversant with trusts, the trust document is often an impediment for donors. If donors feel they have to go to an attorney to draw up a special trust, that’s just one more bump in the road toward reaching their goal. The gift annuity bypasses that bump in the road. It’s a simple contract between the donor and the charity.” The donor receives fixed payments for life from the charity and the charity receives the residuum at the donor’s death.

Hample’s clients benefit from a peculiar Montana law offering special state income tax advantages for planned gifts made for endowment purposes. A few other states also offer this endowment tax credit (credit, not deduction) that can be as high as 50 percent of the federal deduction. For a \$30,000 gift annuity with a gift value calculated at \$15,000, the state tax credit could be \$7,500. While Hample doesn’t receive any fees on the investment of this annuity, he acknowledges that he now has a very loyal client with a wide variety of other financial planning needs.

Gifts of life insurance offer a low cost alternative to CLTs. David Bohannon, CFP, LIC, with Consultants Corner Inc. in Louisville, Kentucky, works only with no-commission life insurance products. The bulk of his business

involves reviewing policies and placing products in conjunction with fee-only financial planners.

A founding member of the Kentucky Planned Giving Council and a planned giving consultant for local charities, Bohannon counsels planners on how their clients can donate to charity in a down market. One approach with clients is to tell them that instead of giving their money to charity, why not just lend their money to charity? This is essentially what a CLT does. Bohannon does the same thing with life insurance.

Consider a risk-averse 60-year-old client with a \$100,000 certificate of deposit (CD) paying three percent. Afraid of running out of money, the client wants to benefit charity, but does not want to give up ownership. Bohannon might advise a client in this situation to buy a \$1 million second-to-die life insurance policy with no load, no fees and no surrender charges for two annual premium payments of \$50,000 from the CD proceeds. The growth in the policy's cash value accumulates at least as quickly as the interest on the CD and the cost of insurance is actually less than the taxes the client would pay on the CD interest. If the client suddenly needs the money, he can withdraw or borrow from the policy up to the cost basis. Or the client can choose eventually to give the cash value to his children, and the balance of the death benefit to charity.

Charitable Intent and Advisor Opportunity

The charitable sector's resilience in tough economic times illustrates the complexity of donor motivation. As Cincinnati's Daniher reflects, "It's important to emphasize that donors must have charitable intent. If they're giving to charity just to save on taxes, they're not really going to be happy in the end. There is no free lunch."

Once again, Floridian Rutherford looks at things a bit differently. "Charitable giving is both a matter of charitable intent and financial strategy. We've had clients with little charitable intent who find the charitable strategies useful."

The National Committee on Planned Giving's 2000 survey of donors uncovered a complex network of motivations behind charitable giving (see *Journal of Gift Planning*, 5, 1, First Quarter 2001). When asked about their motives for making charitable bequests, 97 percent of the respondents listed the desire to support charity, while only 35 percent listed the desire to reduce taxes as a factor. But when asked about their motives for establishing CRTs, 91 percent listed the desire to support charity and 76 percent listed the desire to reduce taxes. Motivation and vehicle choice are clearly interdependent.

Another interesting trend in the NCPG report showed an increasing role for planners in the world of charitable giving. "When donors were asked to identify the origin of the idea for their planned gift, we found that financial and legal advisors provided the impetus in 29 percent of the cases for charitable bequests and 68 percent for CRTs, *both up roughly five times the comparable 1992 results.*"

The good news for planners? First, charitable giving is not totally dependent on economic prosperity. Second, for-profit planners are taking on a growing role in promoting and executing charitable gifts. Put these two trends together and there should be plenty of opportunity for planners interested in charitable gift techniques for clients, especially as the economy begins to turn around.

As Don Scholz summarizes the situation, "Some of our clients are more charitable than others, so we look for some economic benefit the client can derive from a charitable gift. We're also trying to show the client how he or she can build more social capital with these vehicles instead of just letting their money all go to the government and letting the government decide how to use it."

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