Charitable Giving

Five common methods that can favorably affect your tax liability.

BY MEGAN KUCHAN

THE DECISION TO DONATE to charity is a deeply personal one. It's frequently an action motivated by a desire to offer assistance, but other times it stems directly from an interest in tax savings. Whatever the reason, there are a few tax consequences to consider before donating to one of the more than a million qualifying charities.

First, most taxpayers receive an income tax deduction in the year a gift is made. Second, gifts to qualifying charities are not subject to federal gift tax. Third, gifts to charities reduce your taxable estate, which in turn reduces your potential estate tax liability. Whether it's a factor in your decision or not, charitable giving can favorably influence your tax liability.

Just as the desire to be philanthropic and the scale of contribution are personal choices, the optimal method of donation also depends on personal preference. Here are five common methods used to donate:

1. Outright gift. This is the simplest method. In this situation, the charity is the sole beneficiary of a donor's gift and will take possession of the gift immediately. In this arrangement, generally the gift is made to a charity in the form of money or property before the end of the tax year to be deductible for income tax purposes.

2. Bargain sale. In the context of charitable giving, a bargain sale is a sale to a charity at a price below fair market value. The difference between the sale price to the charity and the actual fair market value of the asset is the amount of the donation to the charity. In essence, there are two separate transactions in a bargain sale: the sale and the charitable gift. Each of these is treated as a separate transaction and reported separately for income tax purposes.

3. Split interest gift in trust. Another option is to split your gift between a charity and a noncharitable beneficiary. This can be accomplished with the charity either being the final beneficiary or the initial beneficiary. In the case of the former, the noncharitable beneficiary usually receives the use of donated property for a specific period of time, typically by receiving a certain sum every year from the donated property. After this time period is over, all remaining property passes to the charity. Through this method, the charity's right to possess the gift is delayed since the noncharitable beneficiary has the initial interest in the donated property. This would ordinarily result in no tax deductibility for the donation. However, as long as the gift is set up as one of a number of special trusts expressly created for this purpose, the donor receives federal income, gift and estate tax deductions. Alternatively, if the charity has first interest in the gift, the charity is paid a certain amount every year during the term of the trust. At the end of the trust term, all remaining assets pass to the secondary, or noncharitable, beneficiary. In this situation, the donor still receives a deduction in the year of the original gift.

4. Private foundation. A private foundation is a separate legal entity (often named for the donor) that can endure for generations after the original donor's death. After the donor creates the foundation and transfers assets, typically appreciated assets, the foundation makes grants to public charities. The donor and his or her descendants retain complete control over which charities receive grants from the foundation.

5. Donor-advised fund. Similar to a private foundation, a donor-advised fund (DAF) offers an easier way for a donor to make charitable gifts over a period of time. A DAF actually refers to an account that is administered by a charitable organization. After the donor transfers assets to the DAF, the charity becomes the legal owner of the assets and has ultimate control over them. After transfer, the donor cannot direct, but only advise, as to how the charitable organization distributes the donor's contributions to other charities.

If you're philanthropically inclined, it makes sense to consider carefully the manner in which to donate before making sizable donations. Consult your tax adviser regarding your specific situation and to take advantage of timing benefits related to marginal tax rates and limitations. No matter the method, though, there are benefits — both tax related and non-tax related — to charitable giving.

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