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COMMUNITY FOUNDATION OF NEW JERSEY

HOW TO GIVE TO CHARITY

IN THE MOST TAX-EFFECTIVE WAY

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You want to accomplish as much as possible when you donate to charity. Beyond contributing to worthy causes, that means allocating your resources as tax-efficiently as possible. Fortunately, a number of income and estate-tax planning strategies can help achieve this.

It's important to assess both how much you can give and identify the appropriate assets to give. In designing and implementing an optimal strategy, it's also important to quantify the probability of success and the potential benefit of using specific planning vehicles.

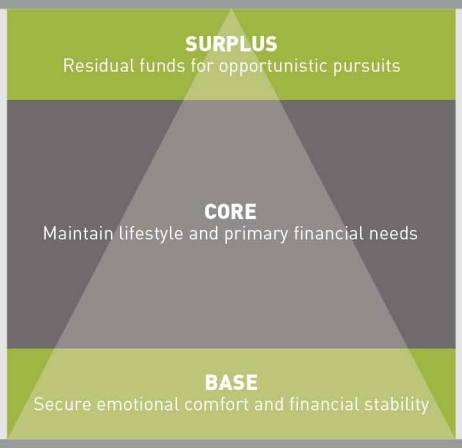
To determine how much you can afford to give, we begin with the planning pyramid shown in Exhibit 1. It starts with a "base" to support near-term spending and provide the emotional wherewithal to stick with the volatility of longer-term investments.

The next step is to quantify the "core capital," or the amount of money needed to endow your lifestyle with a high level of confidence, accounting for poor markets and a potentially long life. Additional resources beyond the base and core — what we call the "surplus" — represents the gifting capacity available for family or philanthropic pursuits.

EXHIBIT 1

Core Planning Framework

Determine how much you can afford to give without jeopardizing your core goals and objectives.



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The Basics

In thinking about which assets to gift and which vehicles to leverage, it's important to consider income tax rates. By allowing an income tax deduction for charitable donations, the federal tax code in essence allows donors to earmark tax dollars to causes that are important to them.

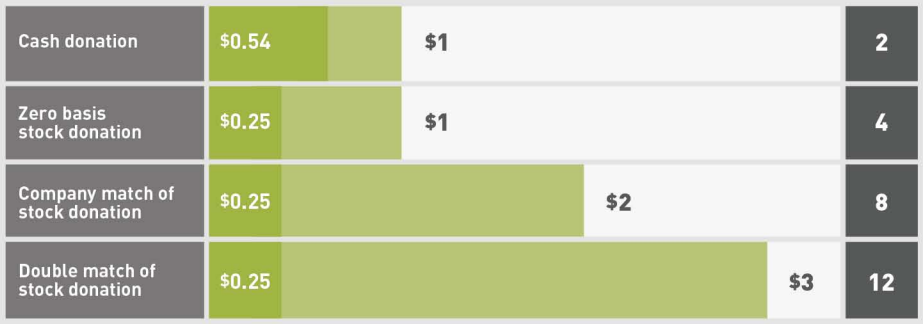
The top federal tax bracket is 39.6%. Adding in the 3.8% Net Investment Income Tax, tax rates on short-term capital gains are 43.4%. The rate on long-term capital gains is 23.8%. Assuming that state and local taxes total about 10%, and are fully deductible on a federal return, the blended rate is roughly 46%.

Exhibit 2 shows how income tax deductions can leverage charitable gifting.

EXHIBIT 2

Bang for the Buck

The potential income tax benefits.



Based on paying top marginal 2015 tax rates.
Reflects benefit of blended federal and state tax deductions. The blended tax rates assume that state taxes paid are claimed as an itemized deduction on the federal tax return. The formula for the blended tax rate is federal tax rate + (1 - federal tax rate) * state tax rate. We have assumed that the full amount of state taxes paid is deductible on the federal tax return (i.e. Pease Limitation does not apply). For purposes of this presentation, we have assumed the highest federal marginal income tax rate on ordinary income, short-term capital gains, and long-term capital gains. In addition, we have assumed all taxable income, including capital gains, is subject to a hypothetical state marginal income tax rate of 10%. Tax rates in this table are based on the rates in effect as of 2015.

"Bang for the buck" is calculated as "value to charity" divided by "cost to you". "Cost to you" compares the cost of selling the zero basis stock to the cost of donating it.

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The Basics (continued)

The first line lists a **cash donation.** A $1 donation qualifies for a 46% deduction, so the net cost is just 54 cents. Put another way, the $1 dollar benefit that goes to charity costs you 54 cents, meaning there is roughly a 2-to-1 "bang for the buck," which is shown in the black box to the right.

The second line shows the effect of **donating stock** — as opposed to selling the shares and donating the proceeds. Taxpayers who donate stock don't have to pay capital gains taxes on any embedded profit. For shares with a zero cost basis, the net cost is only 25 cents, or a 4-to-1 bang for the buck. Taxpayers who work for companies with **corporate matching programs** on stock donations can raise that to 8-to-1. A **double match** can bring the ratio to 12-to-1.

There are two key rules of thumb which can be observed from this illustration. First, donate your lowest-cost basis stocks. Second, make full use of corporate matching dollars.

Of course, the Internal Revenue Service puts a cap on charitable write-offs. Taxpayers who make cash gifts to public charities can deduct up to 50% of income. With stock donations, however, the deduction may be limited to 20% to 30%. Therefore, someone seeking to make a large charitable gift might not be able to take full advantage of the deductions.

Fortunately, there are strategies to maximize charitable giving within these limits.

Private Foundations and Donor Advised Funds

Creating a private foundation or contributing to a donor advised fund may accelerate the potential tax deduction. For example, if you have a high tax year due to the sale of a business or the exercise of stock options, you could create a charitable fund and deduct up to 50% of income.

Thus, you could accelerate the timing of the deduction and minimize the capital gains tax that might otherwise be owed on low-basis assets. You may also be able to qualify for a charitable deduction which may not be possible if your income is lower in future years.

EXHIBIT 3

Private Foundations vs. Donor Advised Funds

The tradeoffs of private foundations vs. donor-advised funds.

	Private Foundation	Donor Advised Fund
Donor control	Yes	Advised
Minimum annual distribution	5% of assets	None
Tax filing required	Yes	No
Excise tax rate	1 - 2%	N/A

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Private foundations and donor advised funds are similar in many ways. For example, except for a small excise tax in a private foundation, money in both vehicles grows tax-free. However, there are important differences in control, complexity and disclosure.

In a **private foundation**, the donor makes an irrevocable gift, but maintains control over how and when the funds are distributed. This can be significant for anyone creating a personal charitable vehicle such as a scholarship fund or supporting an organization with direct community involvement. A private foundation can also establish a family legacy of philanthropy by engaging children in its mission and board meetings. But there are some strings attached. The government requires annual tax filings to ensure that the foundation gives away at least 5% of its assets each year. The entity also must pay a 1% to 2% excise tax on net investment income and publicly disclose all of its activities.

A **donor advised fund**, by contrast, is more confidential and has simpler execution. Provided that you give to established 501(c)3 organizations, you would "recommend" that the fund make a gift and it would do so on your behalf. Donor-advised funds are increasingly being used for their simplicity.

CRTs and CLATs

There are two more advanced strategies that can also maximize charitable giving — in some cases, in combination with donor-advised funds or private foundations.

The first is a **Charitable Remainder Unitrust** or "CRT."

This strategy could make sense for someone with a large holding of low-basis stock who wants to diversify, defer capital gain taxes, receive annual income and donate part of it to charity. These vehicles can make a lot of sense for investors facing potentially high capital gains taxes.

A CRT lets donors contribute assets to a trust that will last for a specified number of years, up to a full lifetime. At the conclusion of the trust term, the remaining assets go to charity. The donor can designate one or more charities to receive the assets, but also retains the option to change those plans. The selected charity may be a public entity, such as an educational institution or house of worship, a donor-advised fund or a family foundation.

CRTs and CLATs (continued)

The CRT may pay a fixed amount or a fixed percentage equal to at least 5%, but not more than 50%, of the initial fair market value to the beneficiaries. A fixed amount, is called an annuity amount. A fixed percentage is called a unitrust amount.

Unitrusts are more common as they tend to align the interests of the donor, who receives steady income, and the beneficiaries. As the trust assets grow, so do the income distributions. In the accompanying example, assume that a 60-year-old couple has $1 million of low-basis stock. They could put the shares into a CRT, sell them and invest the proceeds in a well-diversified portfolio. They can set up the trust so that they would receive an annual income for life of 9% of the value (revalued annually).[1] This would amount to $90,000 in the first year. They'd also get an immediate $107,000 tax deduction.

EXHIBIT 4

Charitable Remainder Unitrust Example

	Example for a 60 year old couple[2]
☑ Lifetime income[1]	• $1 million trust
☑ Low basis stock diversification	• 9% annual payout for life
☑ Opportunity for tax deferral if using low-basis property	↓
☑ Generally better when interest rates are high	• $107,000 tax deduction[2]
☑ Must be irrevocable	• Upon death of second person, any remainder goes to charity

[1] Income is distributed in the following order until exhausted: ordinary income, capital gains, tax-free income and return of principal. The the extent that trust income is greater than your distribution, it is deferred until you receive it.
[2] Based on the life expentancy of a 60 year-old couple and factors found in Tables F and U(2) in IRS Publication 1458, as well as a 2.2% 7520 rate as of September 2015. Assumes payouts occur at year-end. Charitable deduction is based on an IRS formula that calculates the present value of the expected remainder for charity. These calculations are approximate and performed for informational purposes only.

This is a hypothetical illustration and does not reflect the investment results of any specific portfolio now does it guarantee any future results.

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

Even better, donors only pay capital gains taxes on the sale of the stock as they receive income distributions, so the tax can be deferred for many years. This tax deferral is so beneficial that, should the client live past his or her life expectancy, the donor may end up better off from a purely personal wealth standpoint. A unitrust may invest primarily in equities, as historically superior growth prospects can create a higher annual income payout and a higher remainder.

In the case of an annuity trust, the donor might prefer a more bond-oriented approach to provide greater certainty that the annual payment will be made. The payout rate and term will also factor into the asset allocation, including whether to use taxable or municipal bonds. Taxable bonds are typically preferred when the goal is it to maximize the charitable remainder. But due to the nature of the four- tier taxation of the payouts,[2] municipal bonds might be preferable to try to maximize the amount going to the donor. This will be highly dependent on assumptions for bond returns.

To assess the probability of a donor meeting their desired objectives, we evaluate 5,000 potential future scenarios using a Monte Carlo simulation. This is a statistical technique that calculates a range of outcomes and probabilities based on both a client's future spending needs and assumed market returns. Exhibit #5 shows that taxable bonds would result in a higher charitable remainder, with an ending value of $11.4 million versus $10.7 million. Conversely, municipal bonds provide a higher after-tax cumulative payout to the donor ($8.3 million versus $8.1 million).

[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 next tier is deemed to be distributed.

Keep in mind that this is an irrevocable gift. If a donor dies before the term of the trust matures, the entire amount goes to charity. It's similar in that way to buying a lifetime annuity. And while this strategy benefits from the relatively high tax rates in place today, the charitable deduction would be lessened by the current low interest rate environment. People who have charitable intent and low-basis stock that they would like to diversify should consider a CRT.

EXHIBIT 5

Taxable vs Municipal Bonds

Example: $10 million initial value

20-year Ending Values	After-tax Cumulative Points	Charitable Remainder
Taxable bonds	$8.1 million	$11.4 million
Municipal bonds	$8.3 million	$10.7 million

Note Values above are for the median outcome of a 70% Global Equity and 30% bond portfolio. Tax rates assume federal rates only of 39.6%. Results are based on a CRUT with a 5% payout. Please see notes on Wealth Strategy Analyses.

The final option is a **Charitable Lead Annuity Trust**, or CLAT.

This can be a great vehicle for someone with both estate planning and philanthropic objectives. In effect, you continue the charitable giving you already do and add an estate-tax benefit.

The CLAT is in many ways 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 non-charitable 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 are more common.

Suppose you give $50,000 a year to charity and plan to continue for the next 20 years, for a total of $1 million.

EXHIBIT 6

Charitable Lead Annuity Trust (CLAT)

	Example[2]
☑ Estate tax benefit	• **Fund CLAT with $802,000**
☑ May be more advantageous when rates are low	• **Payout of $50,000 per year**
☑ Immediate deduction for future charitable contributions[1]	• **20 year life**
☑ Income and gains taxable to grantor	↓ • **If portfolio compounds at 6% annually, approximately $733,000 would remain for children free of estate or gift tax**

[1] 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.
[2] Based on a 20-year term for the trust and a 2.2% 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.

This is a hypothetical illustration and does not reflect the investment results of any specific portfolio now does it guarantee any future results.

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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% 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 heirs free of gift and estate taxes. You can see in this example that, with a modest investment return of 6%, $733,000 would be left over. That's about 90% of the amount placed in the trust. This vehicle can allow donors to give significantly more to their charities gifting without necessarily affecting the amount left to their heirs.

This strategy greatly benefits from today's low interest rates and will be less effective when rates normalize.

Typically, CLATs are funded with a greater portion in stocks than bonds. But while a higher weighting in equities may provide substantial asset growth for beneficiaries, donors need to consider the potential risks, including the possibility that assets could be exhausted sooner than expected.

Another result of a Monte Carlo simulation appears in exhibit #7 below. A donor creates what is known as a "zeroed-out" CLAT with a 20-year term and funds it with $10 million. The median remainder values left to the beneficiaries is higher for a stock-heavy portfolio of 80/20 compared with a balanced portfolio of 60/40. But the probability of having a value at the end of the term left to the beneficiaries improves from 85-90% to 90-95% with a more balanced mix. Thus, consider adding more fixed income to the mix as the trust term shortens.

EXHIBIT 7

"Zeroed-out" CLAT

Example[2]

Donor creates a "zeroed-out" non-grantor CLT with a 20-year term and funds it with $10 million. The payout is based on a Section 7520 rate of 2.0%.

	80 / 20 allocation	60 / 40 allocation
Probability of ending value → 0	85% - 90%	90% - 95%
Remainder value	$8.5 million	$6.7 million

Note Median remainder value. In the 80/20 allocation, the trust is allocation 80% to global equities and 20% to US taxable bonds. In the 60/40 allocation, the trust is allocated 60% to global equities and 40% to US taxable bonds. Assumes that charitable payout fully offsets taxable income. Please see notes on Wealth Strategy Analyses.

Fortunately, there are a number of techniques which can be used to achieve your charitable and legacy goals. To optimize your philanthropic impact, we would work with you to understand your objectives and then quantify the trade-offs of meeting them using different value-added strategies.

Disclaimer

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.

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Notes on Wealth Strategy Analyses: Stocks are represented by global equity and bonds by either US municipal bonds or US taxable investment grade bonds as noted. The calculation takes into account federal taxes at the top marginal rate of 39.6% as well as the Medicare investment surtax based on the tax bracket created by the investment income. We've assumed that the full amount of state and local taxes paid is deductible on the federal return (for example, the Pease Limitation has been taken up by other deductions).

Data for capital market assumptions doesn't represent past performance and isn't a promise of future results. The assumptions used in the calculations are as follows: the expected return is 6.5 percent for stocks, 2 percent for municipal bonds and 2.75 percent for taxable bonds. These assumptions shouldn't be interpreted as the view of Capital Group Private Client Services. They're provided for informational purposes only and aren't intended to make any assurance or promise 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.

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For more information, consult your financial planner or tax professional.

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