TAX SAVING THROUGH GIFTS TO EDUCATION

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Many persons who are interested in contributing to the vital needs of education can give far more than they realize by careful tax planning. The purpose of this article is to outline some of the effective methods for maximizing educational gifts and at the same time minimizing their after-tax costs to the donor.

Although Americans always have been notably imbued with the spirit of selfless giving for worthy causes, it has nevertheless been the policy of government to encourage gifts for eleemosynary purposes by means of tax concessions. As long ago as 1917 Congress first provided an income tax deduction for charitable contributions by individuals up to a ceiling of fifteen per cent of taxable income. In 1952 this ceiling was raised to twenty per cent of taxable income,¹ and in 1954 to thirty per cent.²

It should be noted that the ten per cent increase authorized in 1954 was made applicable only to contributions to a church or a convention or association of churches,³ a hospital whose principal

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¹ Concerning this increase in 1952, the Senate Finance Committee stated: "Your committee is of the opinion that by increasing the 15 per cent limit to 20 per cent, much-needed relief will be given to colleges, hospitals, and other organizations who are becoming more and more dependent upon private contributors to enable them to balance their budgets and carry on their programs. The plight in which many of our educational institutions find themselves at the present time is due to the fact that their endowment income is inadequate to meet rising costs. It is only through supplemental gifts by the alumni or other persons interested in the cause of education that they are able to continue their programs. Many of the smaller colleges whose alumni have not sufficient means to make adequate contributions are able to continue their existence only through gifts or contributions received by one or two prominent families in their community. Your committee believes that it is to the best interest of the community to encourage private contributions to these institutions and it is believed that this amendment will provide some assistance in this respect."

² Int. Rev. Code of 1954, § 170. Concerning the change in 1954, the Senate Finance Committee said: "This amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds." S. Rep. 1622, 83d Cong., 2d Sess., 1954.

function is providing medical or hospital care or medical education, and an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. In 1956, the categories which qualify for the additional ten per cent contribution deduction were extended to include a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital, subject to specified conditions; and in 1962 they were further extended to include an organization or foundation organized and operated exclusively to receive, invest and administer property and to make expenditures to or for the benefit of a qualified college or university which is an instrumentality of, or is owned and operated by, a State or political subdivision thereof. Summarizing the foregoing provisions, it may be said that while a person’s deduction for charitable contributions is generally limited to twenty per cent of his adjusted gross income, the deduction may be extended to thirty per cent if the additional contributions are for churches, hospitals and medical research organizations, educational organizations, and foundations for colleges and universities of a State or its political subdivisions.

The Revenue Act of 1964 has introduced some liberalizing provisions applicable to individuals. For taxable years after 1963, the additional ten per cent contribution deduction will also apply to contributions to a governmental unit and to a charitable organization, fund or foundation which receives a substantial part of its support from a governmental unit or from the general public. The latter category apparently would include such organizations as the Red Cross, a Community Chest, and libraries and museums which are supported by public or by governmental funds.

Another liberalizing provision of special interest permits the spreading of a contribution of the thirty per cent type which exceeds the percentage limitation. Heretofore, excess contributions of this type were permanently disqualified for the deduction. Under the 1964 Act, a person who makes a contribution eligible for the thirty per cent limitation yet in excess of such limitation, may carry over such excess for a period of five years.

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4 Int. Rev. Code of 1954, §§ 170(b) (1) (A) (iii), 503(b) (5).
5 Int. Rev. Code of 1954, §§ 170(b) (A) (ii), 503(b) (2).
6 Int. Rev. Code of 1954, §§ 170(b) (1) (A) (iii), 503(b) (5).
7 Int. Rev. Code of 1954, §§ 170(b) (1) (A) (iv), 503(b) (3).
8 Int. Rev. Code of 1954, §§ 170(b) (1) (A) (v), 170(c) (1).
9 Int. Rev. Code of 1954, §§ 170(b) (1) (A) (vi), 170(c) (2), 170(c) (1).
10 Int. Rev. Code of 1954, § 170(b) (5).
Corporations as well as individuals may have income tax deductions for charitable, educational and similar contributions. The deduction of a corporation, however, may not exceed five per cent of its taxable income computed as prescribed in the statute.\(^{11}\) When the additional ten per cent deduction for individuals was granted in 1954, corporations were granted a two-year carry over for contributions in excess of the five per cent limitation.\(^{12}\) The Revenue Act of 1964 extended these carry over provisions to five years, subject to specified conditions.\(^{13}\)

In addition to the income tax deduction for individuals, a deduction from the gross estate for federal estate tax purposes is allowed for all bequests to religious, charitable, educational and similar uses.\(^{14}\) This deduction likewise finds its support as a matter of public policy in the social need for such activities and the belief that support of these activities by private means relieves the government to the same extent of public support through taxation. Moreover, the federal gift tax allows a deduction for substantially the same charitable uses as those for the estate tax.\(^{15}\) These uses likewise closely parallel those relating to the income tax. Thus tax planning for charitable and educational gifts must encompass the broad fields of federal income, estate and gift taxes, all three.

In the light of the foregoing historical and statutory survey, we now turn to a consideration of some of the effective methods for maximizing educational gifts and at the same time minimizing their after-tax costs.

**The Gift of Appreciated Property**

Often an alumnus desires to make a gift to his college, but to realize necessary cash he faces the prospect of selling investments which have appreciated in value. If, in fact, the alumnus sells an appreciated investment, he suffers an income tax on the realized gain; after deducting the income tax appropriate to the sale, the alumnus then would pay the residue in cash to his college. Another method is better taxwise. The same charitable result can be achieved and the income tax on the gain avoided if the alumnus directly gives the appreciated investment, in kind, to the college. The gift of appreciated assets to the college is not considered a sale or exchange and the appreciation, representing the gain, escapes


income tax. Yet the alumnus can deduct, within allowable limits, the fair market value of the appreciated investment as a charitable contribution. The college, upon receiving the gift of the investment, can sell the investment, derive tax free cash, and be in the same position as if the alumnus had made a gift of cash to the college. The same result obtains although the in kind gift is in satisfaction of a prior pledge.

An example shows how this simple method can avoid taxable income to the alumnus, yet preserve his charitable deduction upon the gift:

Assume an Alumnus is in a fifty per cent income tax bracket. He owns appreciated stocks valued at $5,000, for which he paid $2,500. The Alumnus desires to give $5,000, in cash, to the College. He has two choices: (1) he can sell the securities for $5,000 and donate to the College the $5,000 in cash, but he suffers a capital gain of $2,500 and must pay the capital gains tax of $625 on the gain of $2,500 (a twenty-five per cent rate); or (2) he can give the $5,000 of appreciated stocks directly to the College, and suffer no capital gains tax whatsoever on the gift. Under choice (2), the College can sell the securities for $5,000 and will receive $5,000 income tax free; the $625 capital gains tax has been avoided. Under choice (2) the Alumnus has been able to make his $5,000 gift to the College, but with a personal savings of $625.

In short, the gift of appreciated property to a college is a highly attractive, yet simple, tax tool in our inflationary economy.

The Bargain Sale

While the gift of appreciated property is of great utility, a bargain sale is often even more appropriate from the alumnus' tax and financial standpoint. If a bargain sale is used, the alumnus does not "give" the appreciated investment to the college. He instead "sells" the appreciated investment to the college. The college pays the alumnus a purchase price equal to the alumnus' tax basis for the appreciated property. Taxwise, the bargain sale is treated as two transactions: a sale to the college with the sales price equal to the alumnus' cost basis and a gift to the college equal to the excess of fair market value over the sales price.

An example will show the vitality of this technique:

Assume the Alumnus is in the fifty per cent income tax bracket. He owns appreciated securities valued at $5,000 for which he paid $2,500. If the Alumnus, with no thought of a charitable gift, sells the $5,000 of appreciated securities for cash, he will suffer a capital gain of $2,500. The capital gains tax (at twenty-five per cent on the $2,500 gain is $625; the Alumnus would pocket the difference, $4,375. Remember; the Alumnus here did not make a charitable gift but simply sold his stock and pocketed the sales proceeds less his capital gains tax.

Suppose, however, the same Alumnus, with the same securities, desires to establish a charitable program. Instead of selling the appreciated securities for $5,000 and pocketing the proceeds, after tax, of $4,735, the Alumnus sells the same securities to the College for $2,500.

The Alumnus is selling the securities to the College at a bargain rate—his cost for the securities, $2,500. The following results flow from this bargain sale:

1. The Alumnus is paid $2,500 in cash by the College.
2. The $2,500 in cash is free of income tax since it represents a return to the Alumnus of his cost basis for the securities.
3. The Alumnus has made a charitable gift of $2,500 representing the excess of fair market value of the property over the sale price ($5,000 less $2,500).
4. The Alumnus is permitted a personal charitable deduction of $2,500.
5. The Alumnus has avoided the capital gains tax on the sale. Thus, the Alumnus receives $2,500 from the College as the purchase price, receives a reduction in his income tax of $1,250 (a $2,500 charitable deduction at a fifty per cent tax rate), and thus nets, in pocket, from the transaction, $3,750. The College receives a gift of $2,500 (since it acquired securities worth $5,000 for $2,500), yet the Alumnus has only an out-of-pocket cost of $625, compared to his situation if he had sold the securities on the regular market for $5,000. At a cost of $625 to the Alumnus, such sum representing the difference between $3,750 and $4,375, the College has received a gift of $2,500.

While appreciated securities are most suited for the bargain sale, real estate and other appreciated property can be used in the same manner and to the same advantage.

A Charitable Income Trust With Remainder To Family

A charitable income trust is a tax planning device which may permit an alumnus simultaneously to benefit his chosen college, reduce his income taxes and reduce his future estate taxes.

The trust must be an irrevocable trust, established by the alumnus.21 The trust income is accumulated or paid over to a

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named college for a stated period of years—the minimum period is two years. At the end of the trust term, the trust terminates and the corpus is paid to a named member of the alumnus' family, often the wife. The alumnus may not retain a reversionary interest. An example demonstrates the usefulness of this technique:

Assume the Alumnus and his wife are in a fifty per cent income tax bracket. The Alumnus owns $50,000 of securities yielding $2,000 of annual dividends. The Alumnus desires to assist his College. He realizes that he could give to the College, from income each year, the $2,000 of dividends. If he would do this for the next ten years, he would have reported the $2,000 each year as dividend income in his tax return and would have deducted the $2,000 contribution for each of the ten years. In effect, then, he would have paid no income tax on the $2,000 of annual dividends for ten years. However, by establishing the above-described trust, the Alumnus receives a "double income tax deduction" for the $2,000 paid annually to the College for the ten-year period.

The double deduction and a potential estate tax savings are achieved as follows:

(1) The income earned by the trust and paid to the College ($2,000 each year) is exempt, in effect, from income taxation and the Alumnus need not report that $2,000 in his tax return. That establishes the "first deduction."

(2) The Alumnus enjoys a "second deduction." For when the trust is established and the Alumnus transfers the $50,000 of securities to the trustee, he is permitted to deduct the actuarial value of a ten-year income interest: the trust income interest enjoyed by the College. Under federal tables, the actuarial value is approximately thirty per cent so the Alumnus is permitted to deduct in his income tax return, for the year in which the trust is established, thirty per cent of $50,000, or $15,000, as a charitable contribution. This deduction is available (subject to the ceiling limitation which usually can be circumvented by staggered annual gifts) and yet the Alumnus need not include the $2,000 annual dividend income in his income tax return for the next ten years. From a tax standpoint, this is a better financial arrangement than the alternative program of annual personal contribution by the Alumnus.

(3) At the end of the ten-year trust period, the trustee distributes the entire trust principal to the Alumnus' wife. This distribution to the Alumnus' wife may be of substan-

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23 Int. Rev. Code of 1954, § 170(b) (1) (d).
tial estate tax benefit if (a) the Alumnus' estate would be greater than the Alumnus' wife's estate, (b) the Alumnus later should predecease his wife and (c) the Alumnus later should take advantage of the full marital deduction (under the estate tax law) since the trust corpus distributed to the Alumnus' wife before the Alumnus' death, absent special circumstances, will not be included in the Alumnus' estate upon his prior death. The gift tax consequence upon the establishment of the trust usually will be slight compared with the estate tax savings.

A continuation of this illustration highlights the potential estate tax advantage:

(a) Assume that the trust is not established and the present situation is continued without tax benefit:

(i) Disposable income over the ten years: $10,000

The disposable income is the $2,000 annual income from the securities for ten years minus the income tax at a fifty per cent rate.

(ii) Total value of property at the end of ten-year period: $60,000

This value is $50,000 (original capital) plus $10,000 of disposable income accumulated during the ten-year period.

(iii) Reduction of principal upon death of Alumnus: $9,000

Assuming the Alumnus is in a thirty per cent estate tax bracket (giving effect to full marital deduction and assuming Alumnus' wife survives him) the estate tax on the $60,000 would be $9,000.

(iv) The value of property actually passing to Alumnus' family after his death (after reduction for estate tax) would be $51,000.

(b) Assume, however, the establishment of a short-term trust, with income payable to the College for ten years, and the remainder interest in the Alumnus' wife.

(i) The Alumnus would not receive the annual income during the ten years since this income, under the trust, would be payable to the College. None

(ii) The Alumnus' income tax deduction, in the year the trust is established, attributable to the ten-year income interest, is approximately $15,000.

(iii) There is a $7,500 increase in Alumnus' disposable income because of a $15,000 chari-

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Table tax deduction at a fifty per cent income tax rate. $ 7,500

(iv) Thus, the total value attributed to this property in Alumnus’ family at the end of ten years is $57,500.

(v) After ten years, the $50,000 of securities would be owned by the wife, no income would have been received by the family during the ten-year period, there would have been an income tax savings of $7,500, and there should be no estate tax on the $50,000 upon the death of the Alumnus.

The result of the transaction, disregarding usually minimal gift taxes, is this: by foregoing yearly, over a ten-year term, $2,000 of annual disposable income the Alumnus and his wife have given the College $20,000 and yet have increased by $6,500 the assets available to themselves.

USE OF A TRUST FOR CHARITABLE GIVING—REMAINDER INTEREST TO THE COLLEGE

Sometimes an alumnus and his wife, enjoying sufficient spendable income and desiring to make a gift to a college, do not wish to impair or reduce their present spendable income. In short, they wish the gift to be effective upon death. Their objective can be achieved at substantial immediate income tax savings through use of an irrevocable trust established while the alumnus and his wife are living.

To achieve the objective, an alumnus establishes an irrevocable trust which provides that the income be paid to the alumnus and his wife, or the survivor, during their lifetimes and that the trust principal be distributed to the college upon the death of the survivor. Such a trust satisfies the charitable objective of the alumnus, yet reserves income and actually creates greater spendable income to the alumnus and his wife during their lifetimes since immediate income tax deductions are available. A typical example points the way for this tax savings:

Assume an Alumnus and his wife are both age 65. They are in a fifty per cent to sixty per cent income tax bracket and have made adequate provisions for their loved-ones. They wish to make contributions to a charitable organization but are reluctant to deplete their income for the remainder of their lifetimes. They own $100,000 of securities, currently yielding $4,000 of annual dividend income.

The Alumnus and his wife establish an irrevocable trust. The

$100,000 of securities are placed in the irrevocable trust. The irrevocable trust provides that the income be paid to the Alumnus and his wife, or the survivor, during their lifetimes. Only upon the death of the survivor will the trust principal be distributed to the College.

The Alumnus and his wife achieve immediate income tax advantage. If an Alumnus establishes an irrevocable trust, and the life income interest is payable to the Alumnus for his lifetime and remainder interest is payable to a College upon the death of the Alumnus, the Alumnus immediately may deduct, as a charitable contribution, the actuarial value of the remainder interest measured at the time of the gift to the irrevocable trust. Suppose the Alumnus and his wife give to the trust $16,667 each year over a period of six years. Tax tables establish the worth of the remainder interest when the preceding life interest is measured by two lives (here, the Alumnus and his wife, age 65.) The remainder has a value of $9,525 the first year, increasing year by year to $10,670 for the sixth year. The Alumnus and his wife's total income tax deductions for the six years would be $60,587, or approximately sixty per cent of the $100,000 total gift to the irrevocable trust over the six-year period.

The results of the program are as follows:

(1) The Alumnus and his wife receive $4,000 a year from the irrevocable trust—their annual income is fully preserved.

(2) The Alumnus and his wife have income tax deductions commencing in the first year in the amount of $9,525, and during the six-year period have income tax deductions totaling $60,587. The income tax deductions substantially reduce the income taxes of the Alumnus and his wife during this six-year period.

(3) The Alumnus and his wife have more spendable income since their income taxes have been materially reduced during the six-year period.

(4) The Alumnus and his wife will continue to receive $4,000 a year until the death of the survivor; then the irrevocable trust principal will be paid to the College and the charitable program desired by the Alumnus and his wife will be fully operative.

(5) The gift tax, if any, incurred upon creation of the trust is usually minimal after the gift exclusion and charitable deduction are applied. Thus, the Alumnus and his wife increased their spendable income for the years in which the transfers were made, retained spendable income during their joint lifetimes, and realized the desire that ultimately the College would be the beneficiary of their endowment under the irrevocable trust fund.

LIFE INSURANCE ENDOWMENTS

Many tax practitioners recommend adoption of life insurance endowment programs. The tax rules and results are not completely clear but the technique often is designed in the fashion here described.

The alumnus assigns a life insurance policy to the college. The policy would be one already owned by the alumnus or one which he purchased for this purpose. Assume the policy is on the alumnus' life. When the policy is assigned, the college is designated as an irrevocable beneficiary under the policy. Assume further that the alumnus reserves certain rights under the policy, such as the right to consent in writing to the surrender of the policy and to the determination of the settlement option. However, because the college is the irrevocable beneficiary no part of the policy value will inure to the benefit of the alumnus after the assignment. It is expected that the alumnus continue to pay the premiums, but he is not obligated to do so.

The income tax advantages of this program are as follows: the alumnus enjoys a charitable contribution deduction when the policy is assigned; the contribution usually is measured by the "fair market value of the policy." Policy premiums paid by the alumnus after the assignments are deductible by him as charitable contributions.

Thus far, the assignment of the insurance policy and the payment of its premiums present no novel tax savings features; the income tax deduction available in the life insurance situation is available in other property situations. However there should be a unique saving of estate taxes when the alumnus dies.

Assignment of the policy to a college qualifies as a current charitable contribution for income tax purposes. However, a different rule on the same assignment applies in the estate tax area. There, if the alumnus reserves an incident of ownership in the policy, the face value of the policy, although actually paid the college, should be included in the alumnus' estate upon his death for federal estate tax purposes. Yet, there also should be a charitable deduction in determining the alumnus' taxable estate for estate tax purposes since the face value passes to the college upon the alumnus' death. Thus far, there is a washout; if the policy is included in the alumnus' estate, it is deducted in an equivalent amount as a charitable deduction. However, the inclusion and deduction of the policy in

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the alumnus' estate produces a significant estate tax advantage. This advantage stems from the increase in the marital deduction resulting from the inclusion of the policy in the alumnus' estate. This occurs as follows: The marital deduction for the alumnus' estate (assuming his wife survives him) is determined by a formula fixing the marital deduction equal to one-half of the alumnus' adjusted gross estate; therefore, if the alumnus' adjusted gross estate increases because of the inclusion of the life insurance policy in his estate, the marital deduction also increases. The significant fact is, however, that the charitable deduction is taken after the adjusted gross estate is determined. In short, the inclusion of the life insurance policy in the alumnus' estate increases his adjusted gross estate and increases the marital deduction, yet the policy is fully available as a charitable deduction after the adjusted gross estate has been determined.

The concept can perhaps best be explained through an example in tabular form. Table I presents an estate in which there has been no assignment of a policy to a college. Table II represents a similar estate with the addition of a newly issued $100,000 life insurance policy which has been assigned to a college pursuant to a life insurance charitable endowment program.

Table 1: An Estate Without an Endowment Life Insurance Program for the College

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Adjusted gross estate</td>
<td>$300,000</td>
</tr>
<tr>
<td>Less marital deduction</td>
<td>$150,000</td>
</tr>
<tr>
<td>Personal exemption</td>
<td>$60,000</td>
</tr>
<tr>
<td>Charitable deduction</td>
<td>None</td>
</tr>
<tr>
<td>Total</td>
<td>$210,000</td>
</tr>
<tr>
<td>Net taxable estate</td>
<td>$90,000</td>
</tr>
<tr>
<td>Estimated U.S. estate taxes</td>
<td>$18,000</td>
</tr>
<tr>
<td>(not including administration expenses)</td>
<td></td>
</tr>
<tr>
<td>Net to family</td>
<td>$282,000</td>
</tr>
<tr>
<td>Net to college</td>
<td>None</td>
</tr>
<tr>
<td>Total to family and college</td>
<td>$282,000</td>
</tr>
</tbody>
</table>

Table II. Adoption of the Endowment of the Life Insurance Program for the College

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
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<td>Adjusted gross estate</td>
<td>$400,000</td>
</tr>
<tr>
<td>Less marital deduction</td>
<td>$200,000</td>
</tr>
<tr>
<td>Personal exemption</td>
<td>$60,000</td>
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<tr>
<td>Charitable deduction</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$360,000</td>
</tr>
<tr>
<td>Net taxable estate</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

Estimated U.S. estate taxes
(not including administration expenses) $ 5,000
Net to family $295,000
Net to college $100,000
Total to family and college $395,000

A comparison of the tabular presentations shows that through adoption of the endowment life insurance program, the college receives the $100,000 proceeds of the policy upon the alumnus’ death, yet, if his wife survives, his family has an additional $13,000 of assets after death costs.

It seems clear that the income tax deduction is available under this program. However, the law is not entirely clear as to the estate tax consequences of the retained incident of ownership in this situation. It is probable that the estate tax advantage should be achieved since the retention by the alumnus of a “string” over the policy would be treated as an “incident of ownership” for federal estate tax purposes, thus granting to the alumnus’ estate and to the college the substantial benefits outlined above.

CONCLUSION

The foregoing examples represent only some of the permissible avenues of tax planning that enable an alumnus to increase his educational gift by reducing the income tax that would have been paid but for the gift. Through the formulation of careful tax planning an alumnus will be able to take maximum advantage of our present governmental tax policy favoring eleemosynary contributions. Thus, with little if any increase in actual cost to the alumnus, he can assume an even greater role in the maintenance and further development of a key institution within the fabric of our society.