England and America have been described as "two nations, separated by a common language." Despite their many shared traits, there remain numerous differences between them. One such difference can be seen in the area of philanthropy. In recent years, charitable giving (as a percentage of gross domestic product) by Americans has more than doubled that of the English.

Why should it be that, say, wealthy New Yorkers are more interested, on average, than their London counterparts in pursuing philanthropic objectives? While the sociologist or cultural anthropologist may articulate a litany of underlying causes, we believe that the explanation may be, at least in part, tied to differences in tax regimes: the US tax system encourages and rewards charitable giving in various ways that the UK system simply does not, even after the introduction in recent years of a number of additional tax reliefs (such as an income tax relief on gifts of land and quoted shares to charity).

Consider, for example, the US treatment of gifts of tangible personal property and so-called "split interest" gifts made in trust.

Gifts of art, antiques and other tangible personal property

A significant portion of charitable giving in the US occurs in the form of gifts of artwork, antiques and other tangible personal property. If the contribution is to a qualifying charity (generally, one that is publicly supported or one that is privately supported but directly conducts charitable activities beyond grantmaking) that will use the contributed property in furthering of its charitable mission, the US rules permit the donor to deduct the full fair market value of the contributed property. Even if the contribution does not qualify for a full fair market value deduction, the donor generally is permitted to deduct his cost base in the property.

This aspect of the US tax system creates an extraordinary incentive for charitable contributions of highly appreciated collectibles. The incentive is increased further because capital gains on collectibles are taxed at a rate of 28% rather than the normal 15% rate.

For example, suppose a wealthy New Yorker owns a work by Andy Warhol that was originally acquired for $100,000 and has been appraised at $1.1 million. If the owner donated the piece to the Museum of Modern Art, he would be entitled to a tax deduction of $1.1 million, assuming that the appraisal satisfied certain requirements and that the Museum planned to keep the donated piece for its collection. This deduction could be worth approximately $385,000 to the donor, assuming he had sufficient income to utilize it.

By contrast, a wealthy Londoner making a comparable gift to the National Gallery would get no benefit.

Split interest gifts

Another benefit afforded by the US system is the deductibility of so-called “split-interest” gifts. These arrangements involve a donor funding an irrevocable charitable trust in which some current or future interest is retained or assigned to other individuals by the donor.

Charitable remainder trusts

A charitable remainder trust (a “CRT”) is a tax-exempt trust in which named individuals receive trust distributions either during their lifetime or for a fixed term, and thereafter, all remaining trust assets are paid to charity. The trust distributions may be annuities (fixed dollar amounts based on the initial value of the contributed property) or “unitrust” amounts (a fixed percentage of the value of the trust’s assets each year). In either case, the present value of the remainder interest, computed using tables prescribed by the US tax authorities, must be worth at least 10% of the value of the contributed property.

The settlor of a CRT is entitled to an immediate income tax deduction for the present value of the remainder interest, regardless whether the actual value that ultimately passes to charity is greater or less than the amount computed at inception.

For example, suppose a donor funds a 20-year charitable remainder unitrust with a $1 million asset. Under the relevant IRS tables, the donor can receive distributions each year of approximately 11% of the trust’s value at the beginning of that year. If the trust’s assets grow at the rate assumed by the IRS (5.8% per annum in December 2006), the donor will receive distributions totaling nearly $1.4 million over the term of the
trust, and the charity will receive approximately $309,000 of value upon termination of the trust. (Using the 5.8% rate, the $309,000 remainder has a present value of approximately $100,000, or 10% of the initial trust corpus.)

If the trust’s assets appreciate at a rate higher than the assumed 5.8%, the charity will receive an additional benefit upon termination of the trust, but the donor will not receive a further tax deduction. Conversely, if the trust’s assets appreciate at a lower rate, the charity will receive less than the computed amount, but the donor will not lose any of his initial tax deduction.

Charitable lead trusts

A charitable lead trust (“CLT”) is the inverse of a CRT: distributions are made to charity during the term of the trust, with the remainder distributed to non-charitable beneficiaries upon termination of the trust. This technique is often used as a means of generating a current income tax charitable deduction while simultaneously making an intra-family gift at a discounted value. As with the CRT, IRS tables impute present values to the stream of payments to charity and the remainder interest to a family member.

For example, suppose a donor funds a 20-year charitable lead annuity trust with $1 million, with the remainder distributable to his children. Under current IRS tables, if the trust instrument provides for an annuity of $85,774 to charity, the annuity interest will have a present value of $1 million, and the donor will be entitled to deduct that amount, subject to normal limitations on deductibility. Meanwhile, the remainder interest will be treated as having virtually no value, and, as a result, the donor will not be liable to gift tax.

If the trust’s assets appreciate at the rate assumed by the IRS, the remainder interest actually will be virtually zero. However, if the assets outperform the assumed rates, the remainder beneficiaries may in fact receive substantial value without any gift tax being imposed on the donor. If, for example, the trust assets in our prior example appreciated at a rate of 8% rather than the assumed 5.8%, the remainder beneficiaries would receive approximately $736,000 upon termination of the trust.

A CLT thus can be an extremely effective estate planning tool when, like now, assumed appreciation rates are relatively low. Similarly, a CRT can provide a significant income tax benefit with potentially little economic cost when assumed rates are relatively high. In either case, US charities are in a position to reap substantial benefits. Meanwhile, no comparable concept exists in the UK system.

Attitude adjustment

The UK charity sector has assembled a coalition of advisors, charities and fundraisers which has been active in trying to seek cultural shift in the attitude of the UK Treasury in order to increase opportunities for philanthropy in the UK. The proposal, essentially, was that the CRT should be incorporated in one fashion or another into the UK philanthropy tax framework. The coalition’s efforts to date have been frustrated. The UK Treasury launched an assault on trusts in the form of this year’s UK Finance Act, which meant that any attempt to adopt a new structure using a trust is doomed to failure in the current climate. Nevertheless, there are still some hardy souls who continue to pursue this goal, possibly using an annuity structure. We remain optimistic that this cornerstone of fundraising efforts by American charities will one day be replicated across the Atlantic, but for the moment, English charities must make do with less sophisticated fundraising techniques.
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