

# Taxation of Charitable Gift Annuities



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Director of Graduate Studies  
in Charitable Planning  
Texas Tech University

**Ordinary  
Income**

**Tax Free  
Return of  
Investment**

**Capital  
Gain**

**Gift Taxes**



**Charitable  
Deduction**

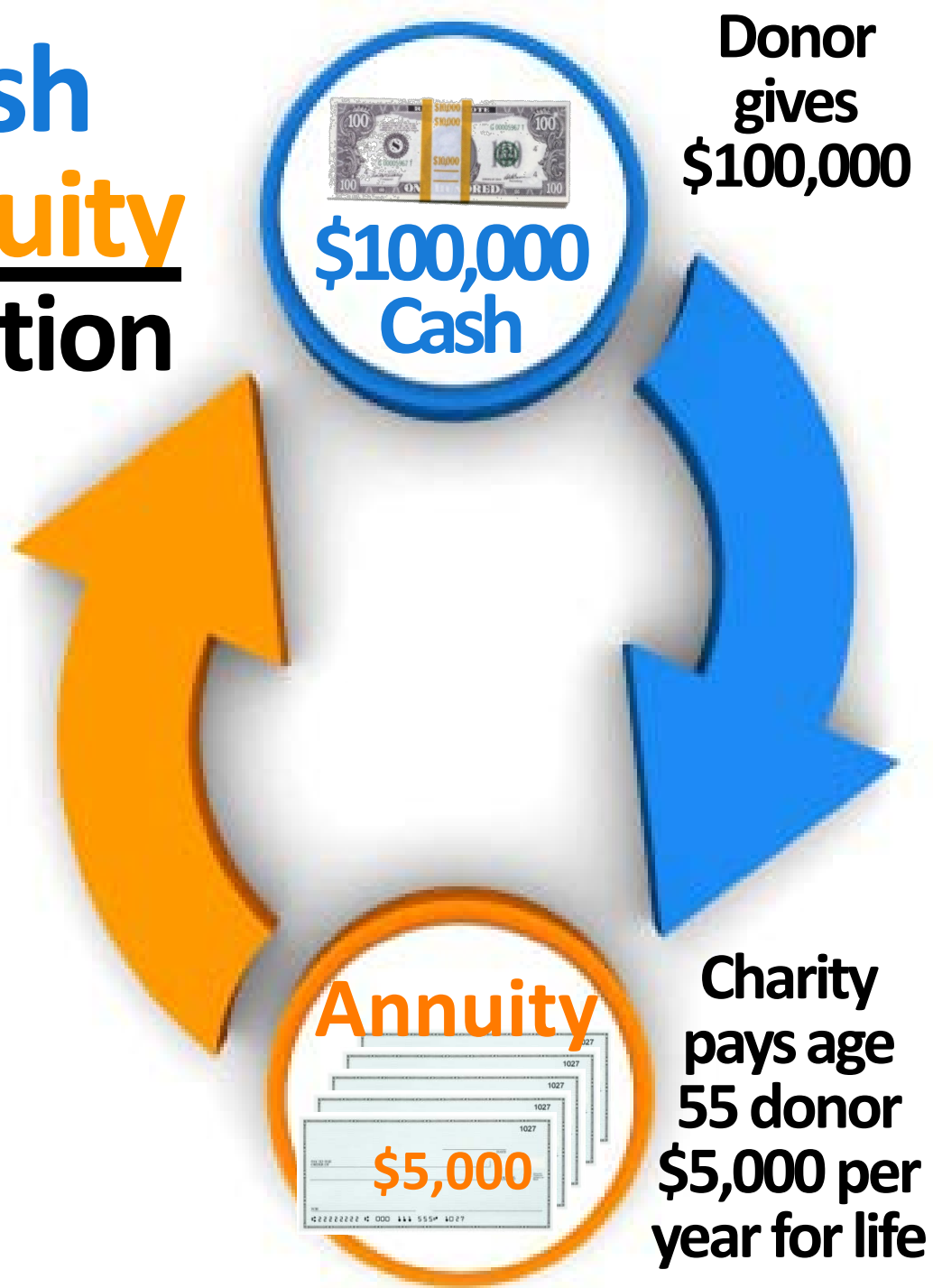
**Annuity**



**Charitable  
deduction  
is the  
value of  
what you  
give less  
the value  
of what  
you get  
back**



# **\$100,000 Cash** **– Value of Annuity** **Charitable Deduction**



**What is the  
value of an  
annuity?**



# Find the §7520 rate

(<http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>)



# Multiply annual payment by annuity factor in IRS Pub. 1457

(<http://www.irs.gov/retirement/article/0,,id=206601,00.html>)



# Value of annuity



# Find the §7520 rate

<http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>

\$5,000/year age 55  
donor on 9/2/10

Section 7520 Interest Rates - Windows Internet Explorer

http://www.irs.gov/businesses/small/article/0,,id=112482,00.html

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Section 7520 Interest Rates

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### Section 7520 Interest Rates

To be used to value certain charitable interests in trusts. Pursuant to Internal Revenue Code 7520, the interest rate for a particular month is the rate that is 120 percent of the applicable federal midterm rate (compounded annually) for the month in which the valuation date falls. That rate is then rounded to the nearest two-tenths of one percent. For example, the rate that is 120 percent of the applicable federal rate (compounded annually) for January 1998 is 7.13 percent. That rate is then rounded to the nearest two-tenths of one percent or 7.2 percent for purposes of IRC 7520.

#### Section 7520 Interest Rates

Valuation Month	120% of Applicable Federal Midterm Rate	Section 7520 Interest Rate	Revenue Ruling
January - 2010	2.95%	3.0%	2010-1
February - 2010	3.39%	3.4%	2010-6
March - 2010	3.23%	3.2%	2010-8
April - 2010	3.25%	3.2%	2010-11
May - 2010	3.45%	3.4%	2010-12
June - 2010	3.27%	3.2%	2010-15
July - 2010	2.83%	2.8%	2010-18
August - 2010	2.62%	2.6%	2010-19
September - 2010	2.33%	2.4%	2010-20

Small Business/Self-Employed

- Industries/Professions
- International Taxpayers
- Self-Employed

Small Business/Self-Employed Topics

- A-Z Index for Business
- Forms & Pubs
- Starting a Business
- Business Expenses
- Businesses with Employees
- Filing/Paying Taxes
- Post-Filing Issues
- Changing Your Business
- More Topics

IRS Resources

- Compliance & Enforcement
- Contact My Local Office
- e-file
- Forms and Publications
- Newsroom
- Frequently Asked Questions
- Taxpayer Advocate Service

I can choose  
current or  
one of last  
two month's  
rate

July 2.8%  
Aug 2.6%  
Sept 2.4%



Value of  
fixed  
annuity

Interest Rates



# Find the §7520 rate

## 2.8%

<http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>

\$5,000/year age 55  
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I want the  
lowest  
annuity  
valuation  
[highest  
charitable  
deduction]  
so I select

July 2.8%

Find the §7520 rate

**2.8%**

<http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>

\$5,000/year age 55  
donor on 9/2/10



Multiply annual payment by  
annuity factor in IRS Pub. 1457

**\$5,000 X 17.2932**

<http://www.irs.gov/retirement/article/0,,id=206601,00.html>

Section 1

**Table S - Based on Life Table 2000CM**

**Interest at 2.8 Percent**

Age	Annuity	Life Estate	Remainder	Age	Annuity	Life Estate	Remainder
0	30.7976	0.86233	0.13767	55	17.2932	0.48421	0.51579
1	30.8780	0.86458	0.13542	56	16.8926	0.47299	0.52701
2	30.7583	0.86123	0.13877	57	16.4893	0.46170	0.53830
3	30.6299	0.85764	0.14236	58	16.0842	0.45036	0.54964
4	30.4953	0.85387	0.14613	59	15.6767	0.43895	0.56105

Find the §7520 rate

**2.8%**

<http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>

\$5,000/year age 55  
donor on 9/2/10



Multiply annual payment by  
annuity factor in IRS Pub. 1457

**\$5,000 X 17.2932**

<http://www.irs.gov/retirement/article/0,,id=206601,00.html>



Value of annuity

**\$86,466**

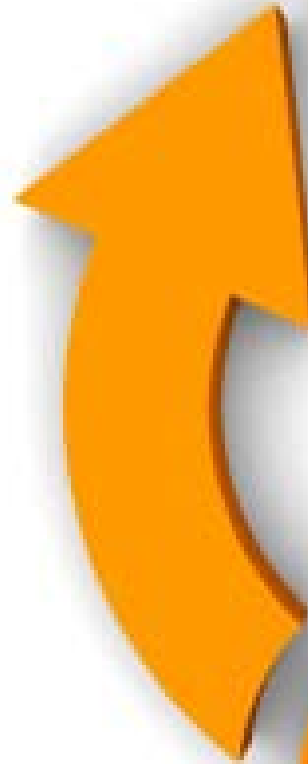
**If annuity  
pays more  
than  
annually, add  
adjustment  
factor from  
Table K**

**\$100,000 Cash**  
**– \$86,466 Annuity**  

---

**\$13,534 Deduction**

**Donor  
gives  
\$100,000**



**Annuity**



**Charity  
pays age  
55 donor  
\$5,000 per  
year for life**

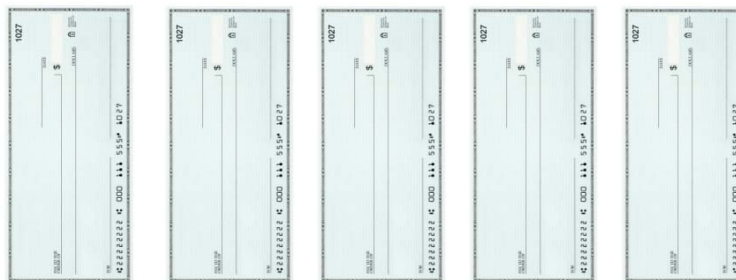
IRS requires  
present value  
of charitable  
share >10%



2010



If charitable  
deduction is  
not >10% of  
transfer, it  
doesn't  
qualify



2011 2012 2013 2014 2015

...



Death



Find the §7520 rate

<http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>



Multiply annual payment by  
annuity factor in IRS Pub. 1457

<http://www.irs.gov/retirement/article/0,,id=206601,00.html>



Value of annuity

**For two  
lives use  
Table R**

**Annuity factor is  
(1-remainder)  
§7520 rate**

Charitable  
deduction  
is the value  
of what you  
give less  
the value of  
what you  
get back





**Ordinary  
Income**

**Tax Free  
Return of  
Investment**

**Capital  
Gain**

**Gift Taxes**



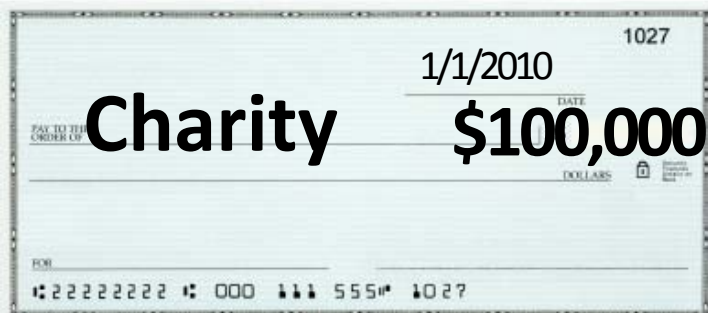
**Charitable  
Deduction**

**Annuity**



# Part of each annuity check just gives you back some of the money you paid

**Initial Gift**



**Annual Payments**

# The rest is earnings (taxable)

**Initial Gift**

**Charity** **\$100,000**

1/1/2010

1027

DATE

DOLLARS



VOID ANY OTHER CHECKS

FOR  
⑆22222222⑆ 000 111 555⑆ 1027

**Donor** **\$5,000**

1/1/2011

1027

DATE

DOLLARS



VOID ANY OTHER CHECKS

**Earnings + Return of Investment**

FOR  
⑆22222222⑆ 000 111 555⑆ 1027

**Annual Payments**

# There is NO tax on getting back your own money

**Initial Gift**

**Charity**

1/1/2010

**\$100,000**

1027

DATE

DOLLARS



VOID

FOR  
⑆22222222⑆ 000 111 555⑆ 1027

**Donor**

1/1/2011

**\$5,000**

1027

DATE

DOLLARS



VOID

**Earnings + Return of Investment**

FOR  
⑆22222222⑆ 000 111 555⑆ 1027

**Annual Payments**

# There IS a tax on getting earnings on your money

**Initial Gift**

**Charity**

1/1/2010

**\$100,000**

1027

DATE

DOLLARS



VOID

FOR  
⑆22222222⑆ 000 111 555⑆ 1027

**Donor**

1/1/2011

**\$5,000**

1027

DATE

DOLLARS



VOID

**Earnings + Return of Investment**

FOR  
⑆22222222⑆ 000 111 555⑆ 1027

**Annual Payments**

Suppose you  
put some  
money in the  
bank



Each year you  
withdraw all  
of the interest  
and some of  
what you  
originally put  
in





Do you pay  
taxes when  
you withdraw  
the money  
you originally  
put in?





Do you pay  
taxes when  
you withdraw  
the money  
you originally  
put in?  
**No.**



**That is like getting your own money back that you buried in the ground**



**That is like getting your own money  
back that you buried in the ground**

**No Taxes**

A person wearing blue jeans is kneeling on a green lawn. They are holding a large, thick stack of US dollar bills in their hands. To their right, a shovel is stuck upright in the grass. The scene is outdoors with trees in the background. The text 'No Taxes' is overlaid in large, red, bold letters across the middle of the image.

Do you pay  
taxes when  
you withdraw  
the money  
you originally  
put in?  
**No.**



Do you pay  
taxes on the  
interest  
earned?



Do you pay  
taxes on the  
interest  
earned?  
**Yes.**



Do you pay  
taxes on the  
interest  
earned?

**Yes.**

That is new  
money you  
didn't have  
before

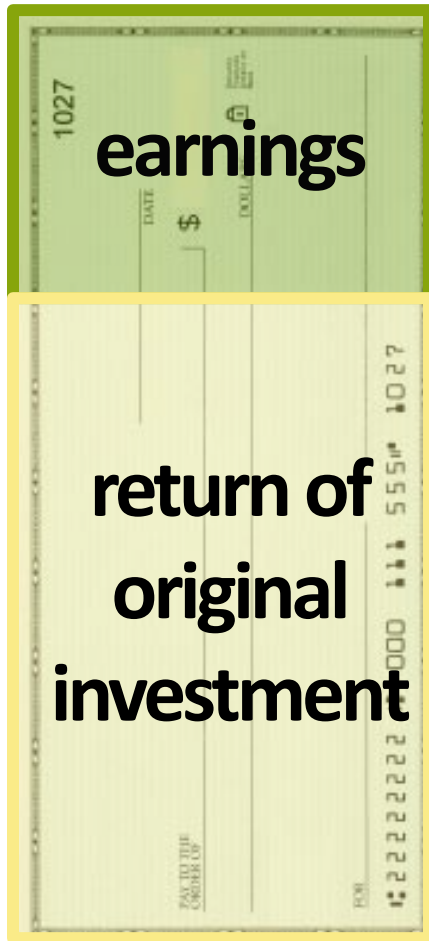




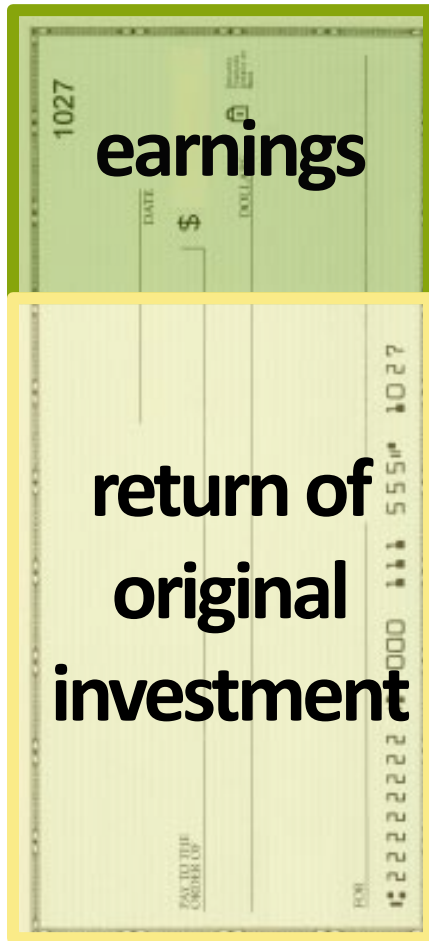
The idea of taking all of the interest and some of the principal each year is similar to an annuity



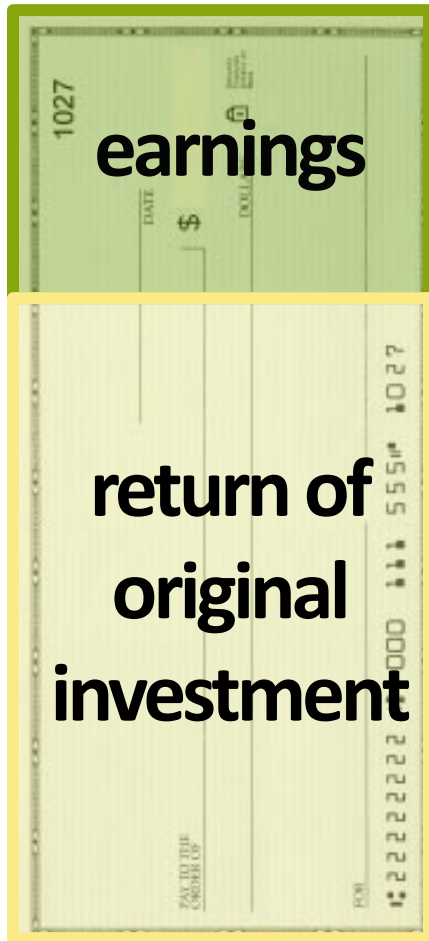




Each annuity check has some earnings and some return of original investment



How much of each annuity check is return of the money you put in originally?

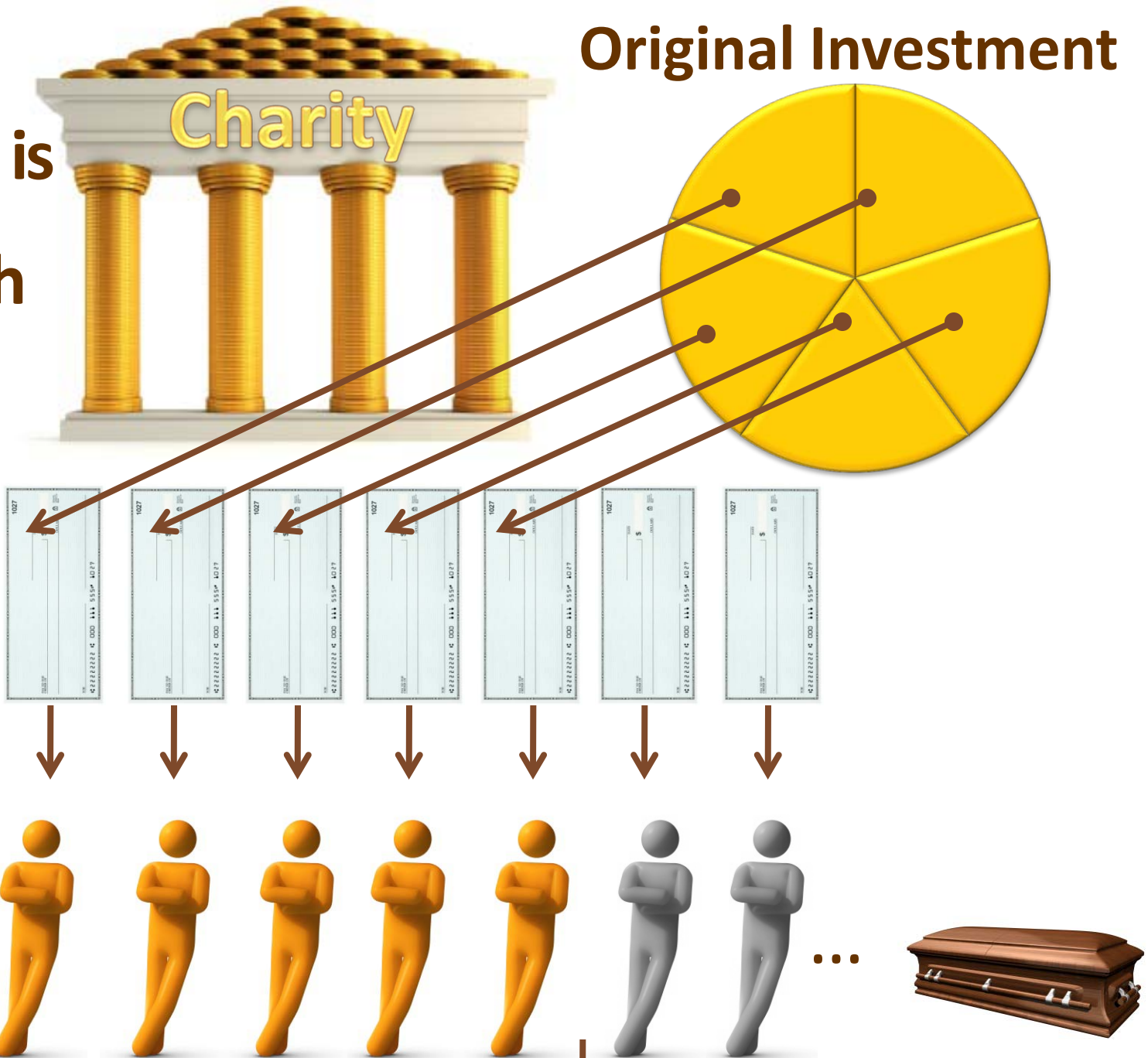


$$\frac{\$ \text{ used to buy annuity}}{\text{Original life expectancy}} = \text{Annual return of investment}$$

**Tax free  
return of  
investment is  
divided  
among each  
expected  
payment**

**Original Investment**

**Charity**

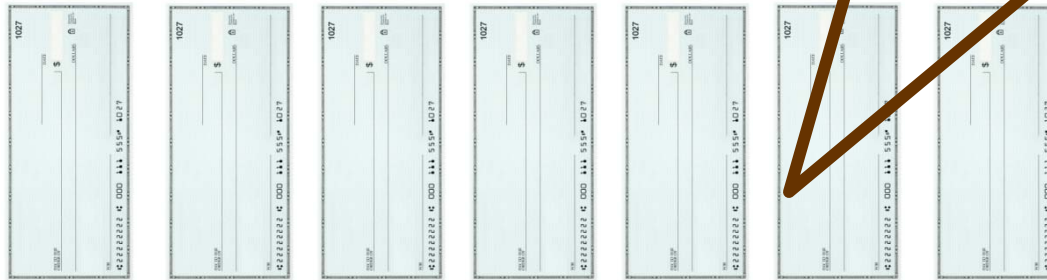


**2010**

**2011 2012 2013 2014 2015 ↓ Life Expectancy**



Annuity payments  
after life  
expectancy are  
100% taxable  
because all original  
investment has  
been returned



2011 2012 2013 2014 2015 ↓ Life Expectancy

2010

**How much of  
each \$5,000  
annuity payment  
is tax free return  
of investment?**

**Donor  
gives  
\$100,000**



**\$100,000  
Cash**

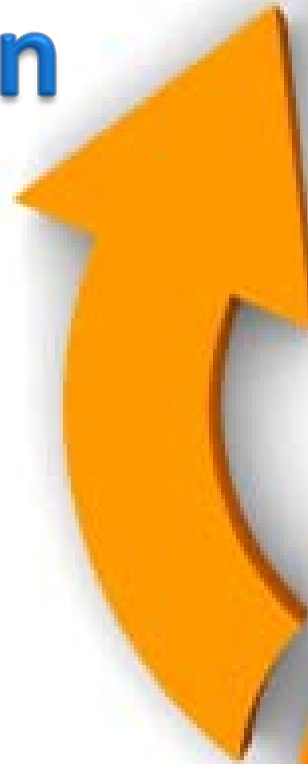


**Charity  
pays age  
55 donor  
\$5,000 per  
year for life**



**Annuity**

**\$5,000**





**How much of  
each \$5,000  
annuity payment  
is tax free return  
of investment?**

**\$ used for annuity  
Original life expectancy**

**Donor  
gives  
\$100,000**



**\$100,000  
Cash**



**Annuity**



**Charity  
pays age  
55 donor  
\$5,000 per  
year for life**

# How much of each \$5,000 annuity payment is tax free return of investment?

**\$86,466 annuity portion cost**

**\$ used for annuity**  
**Original life expectancy**

**21 years\***

**Donor gives \$100,000**



**\$100,000  
Cash**

**Annuity**

**\$5,000**

**Charity pays age 55 donor \$5,000 per year for life**

\*Life expectancies from Reg 1.72-9 [<http://goo.gl/kR5k>]  
Adjustment for payment timing Reg. 1.72-5(a)(2)(i) [<http://goo.gl/so26>]

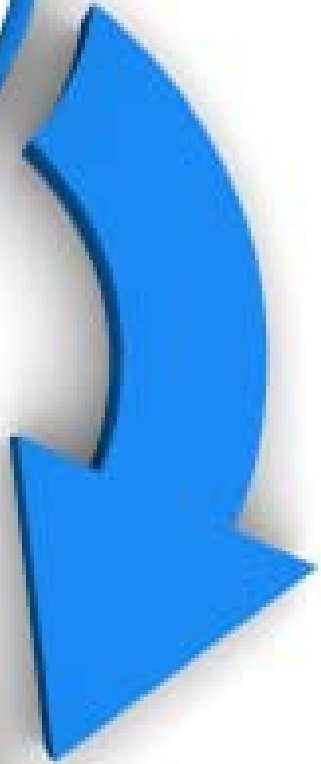


# How much of each \$5,000 annuity payment is tax free return of investment?

Donor gives \$100,000



**\$100,000**  
**Cash**



Charity pays age 55 donor \$5,000 per year for life

**Annuity**

**\$5,000**



**\$86,466 annuity portion cost**

$$\frac{\$86,466}{21} = \$4,118$$

**21 years\***

\*Life expectancies from Reg 1.72-9 [<http://goo.gl/kR5k>]  
Adjustment for payment timing Reg. 1.72-5(a)(2)(i) [<http://goo.gl/so26>]



2010

1027  
**\$4,118**  
Tax free  
return  
of invest-  
ment  
**\$882**  
Ordinary  
income



2011

1027  
**\$4,118**  
Tax free  
return  
of invest-  
ment  
**\$882**  
Ordinary  
income



2012

1027  
**\$4,118**  
Tax free  
return  
of invest-  
ment  
**\$882**  
Ordinary  
income



2013 ...

1027  
**\$4,118**  
Tax free  
return  
of invest-  
ment  
**\$882**  
Ordinary  
income



2022



1027  
**\$5,000**  
Ordinary  
income



Life Expectancy

1027  
**\$5,000**  
Ordinary  
income



...



Death



2010

<b>\$4,118</b> Tax free return of invest- ment	<b>\$4,118</b> Tax free return of invest- ment	<b>\$4,118</b> Tax free return of invest- ment
<b>\$882</b> Ordinary income	<b>\$882</b> Ordinary income	<b>\$882</b> Ordinary income



2011



2012



2013

... Death...



If early death,  
donor's last tax  
return deducts  
original investment  
not yet given back

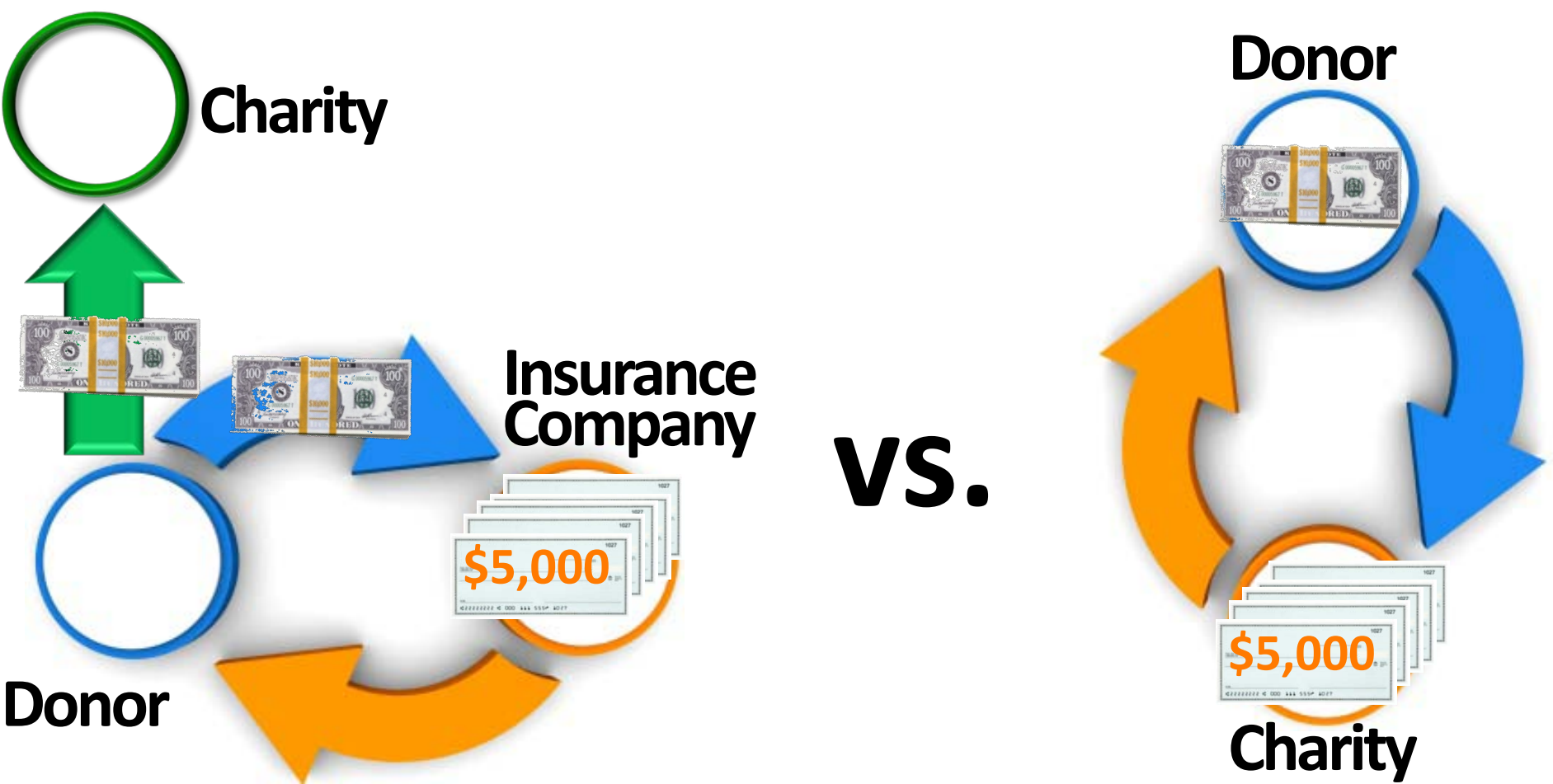


2022

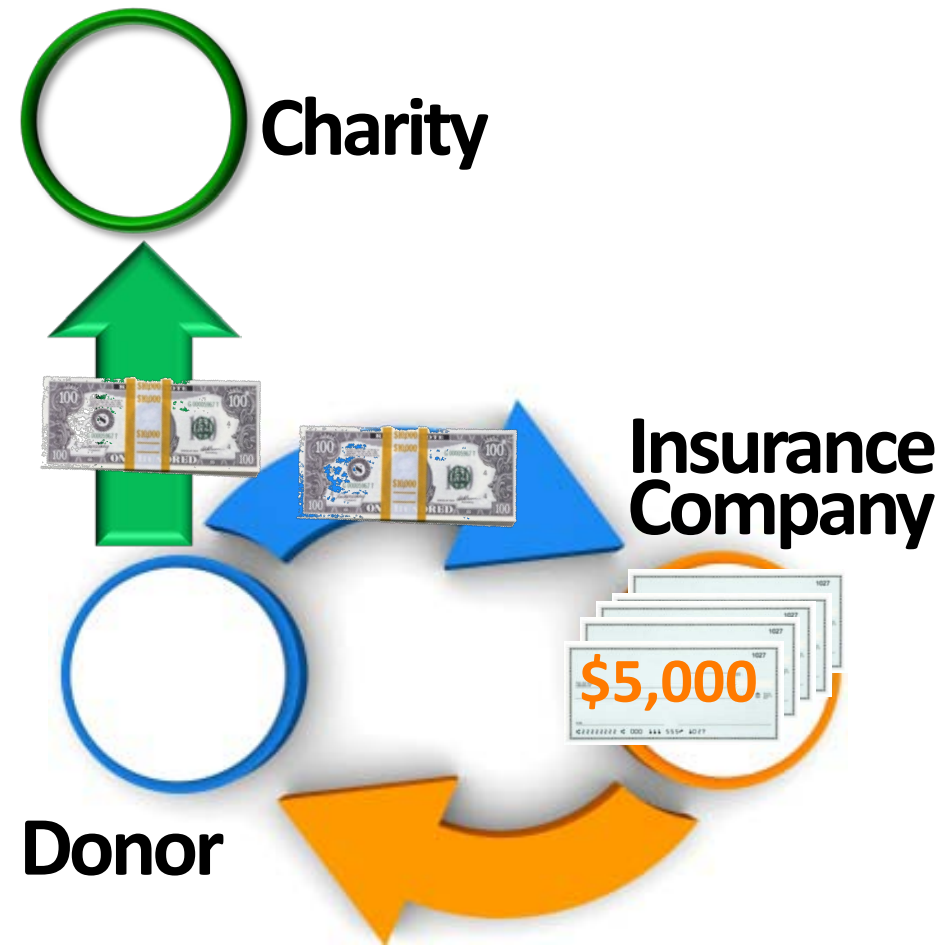


Life Expectancy

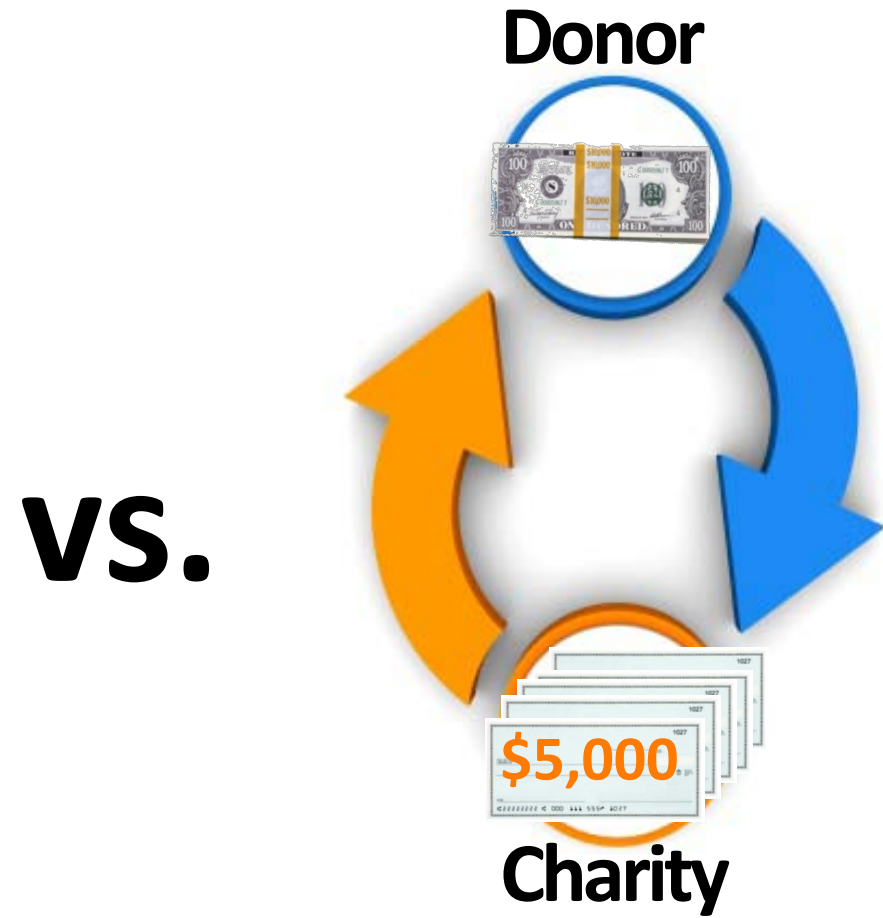
# Compare a cash charitable gift annuity vs. splitting the gift amount between a commercial annuity and an immediate gift



**Original Amount  
– Annuity Price  
Deductible Gift**

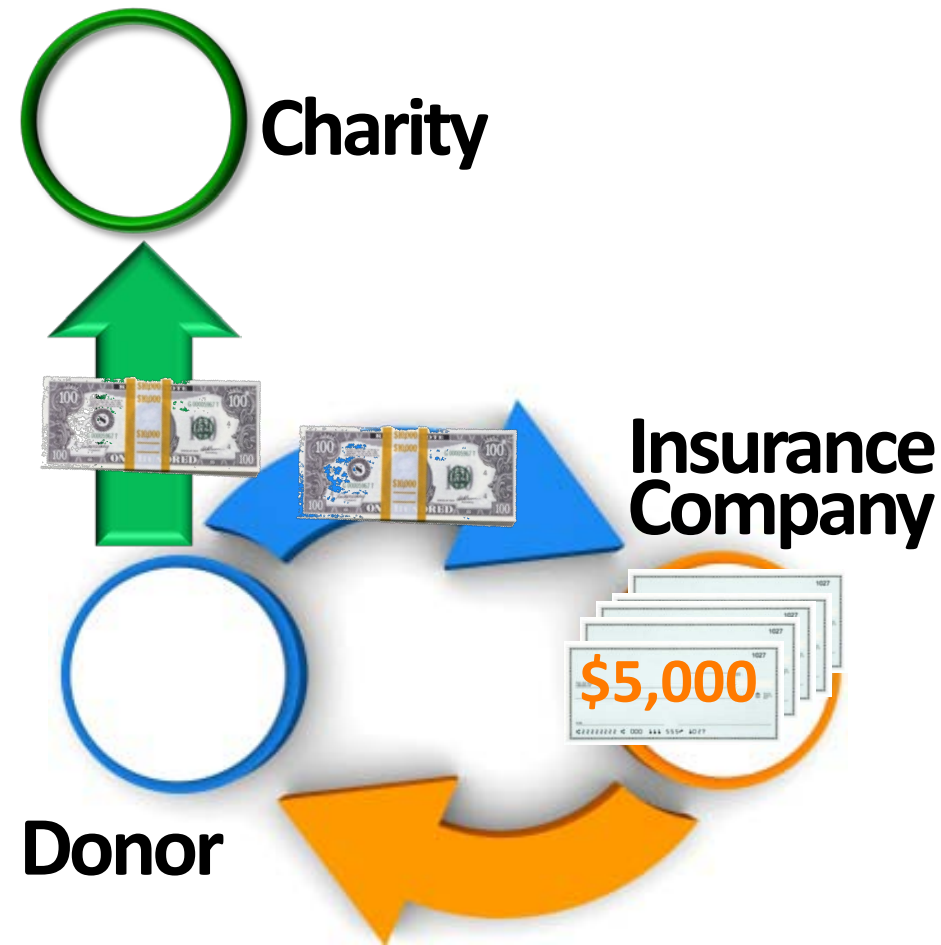


**Original Amount  
– Annuity IRS Value  
Deductible Gift**





**Where the charity does not or cannot  
issue gift annuities in the donor's state,  
suggest this option**



**VS.**



Ordinary  
Income

Tax Free  
Return of  
Investment

Capital  
Gain

Gift Taxes



Charitable  
Deduction

Annuity



# Normal Capital Gain Rules

I paid **\$500,000** for it

I sell it for  
fair market  
value of **\$1,000,000**

I have a  
capital  
gain of **\$500,000**



# Normal Capital Gain Rules

I paid **\$500,000** for it

I sell it for  
fair market  
value of **\$500,000**

I have a  
capital  
gain of **\$0**

I paid

**\$500,000**

for it

I give it to  
charity for  
an annuity  
worth

**\$800,000**

It has a fair  
market  
value of

**\$1,000,000**

I have a  
capital  
gain of

**???**

% of the  
property value  
used for  
annuity

=

% of cost basis  
allocated to  
annuity



# Step 1: Divide property value

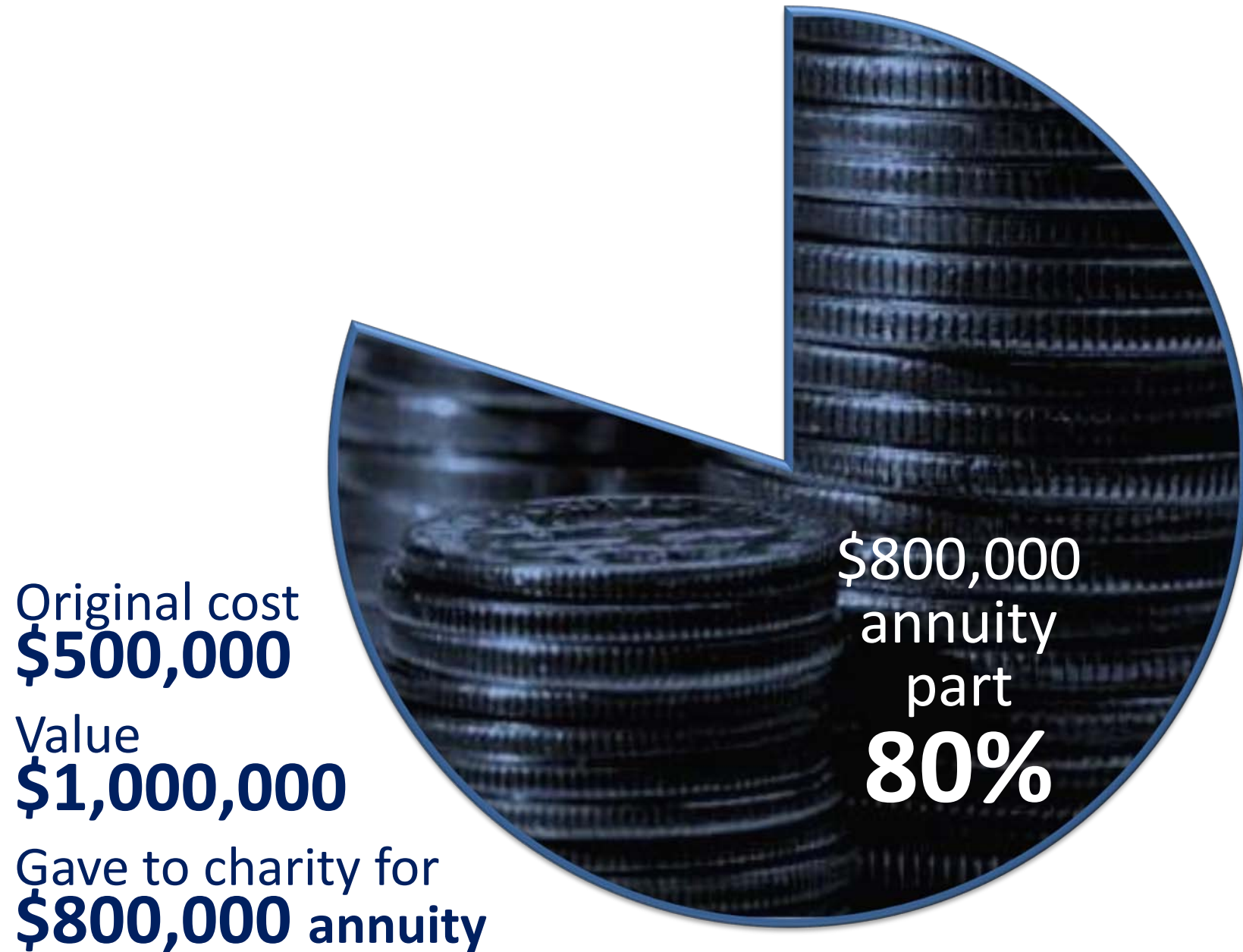


Original cost  
**\$500,000**

Value  
**\$1,000,000**

Gave to charity for  
**\$800,000 annuity**

# \$800,000 of value to donor





# Step 2: Divide cost basis

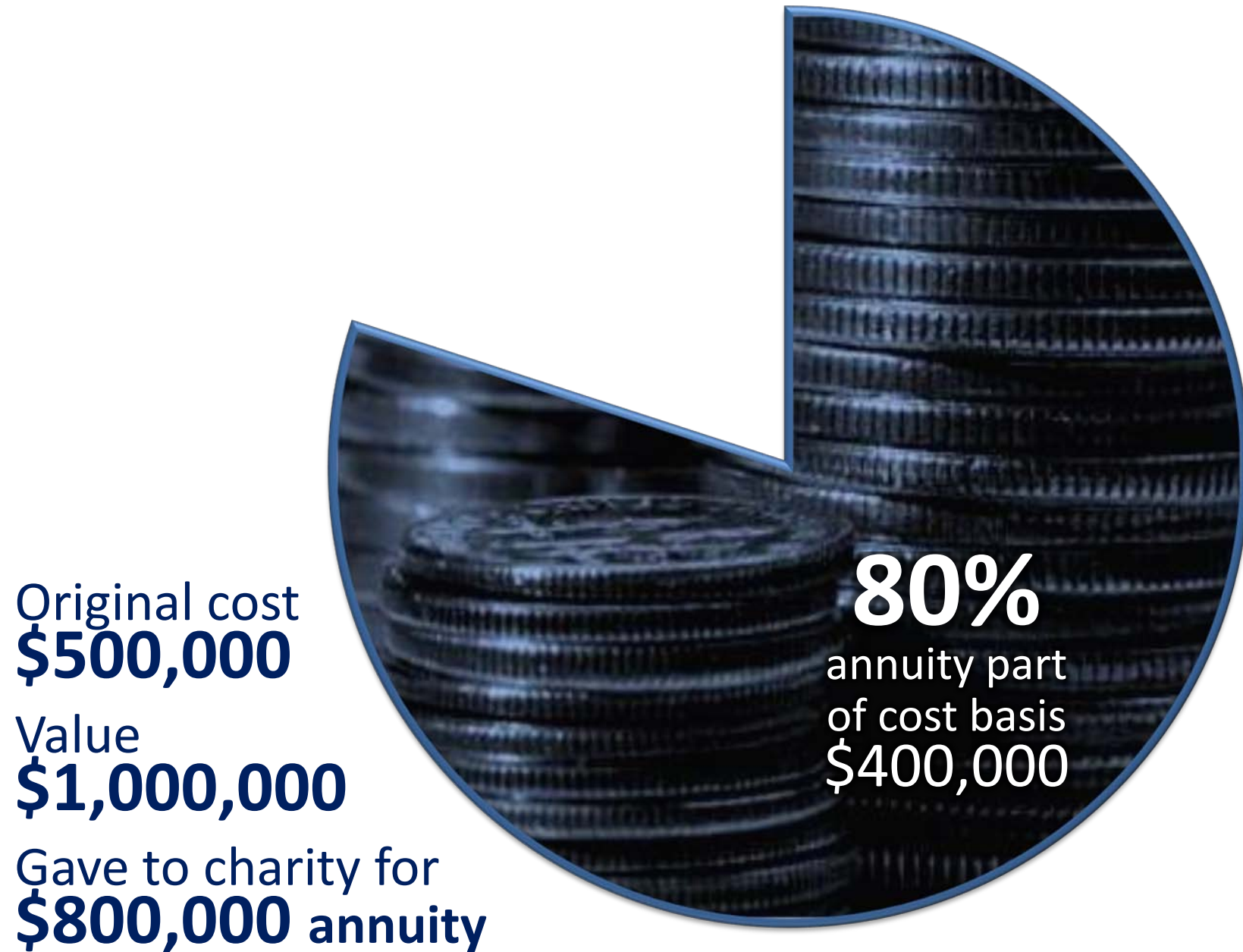


Original cost  
**\$500,000**

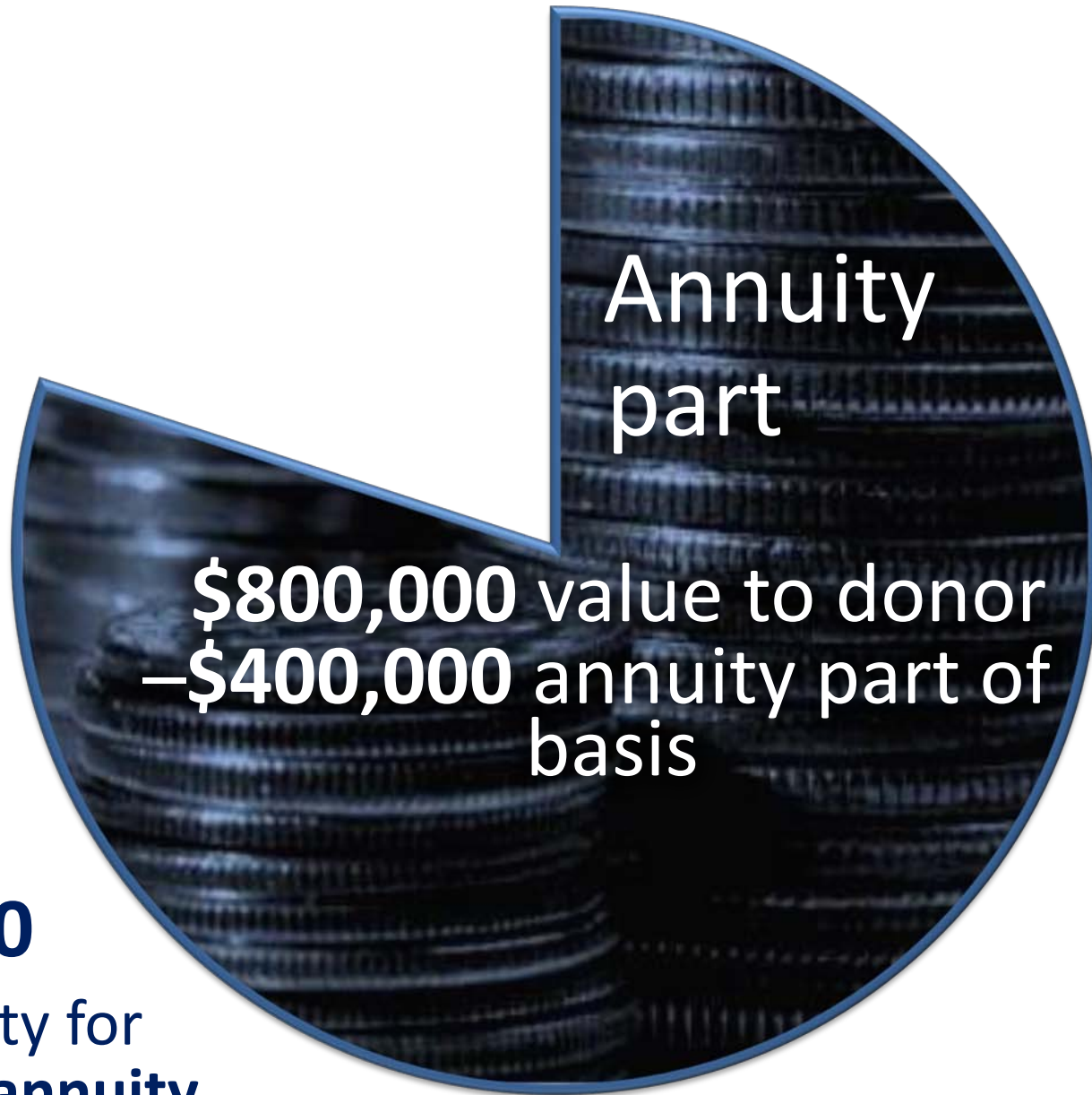
Value  
**\$1,000,000**

Gave to charity for  
**\$800,000 annuity**

# Annuity part of cost basis



# Gain: Annuity value less annuity part of basis



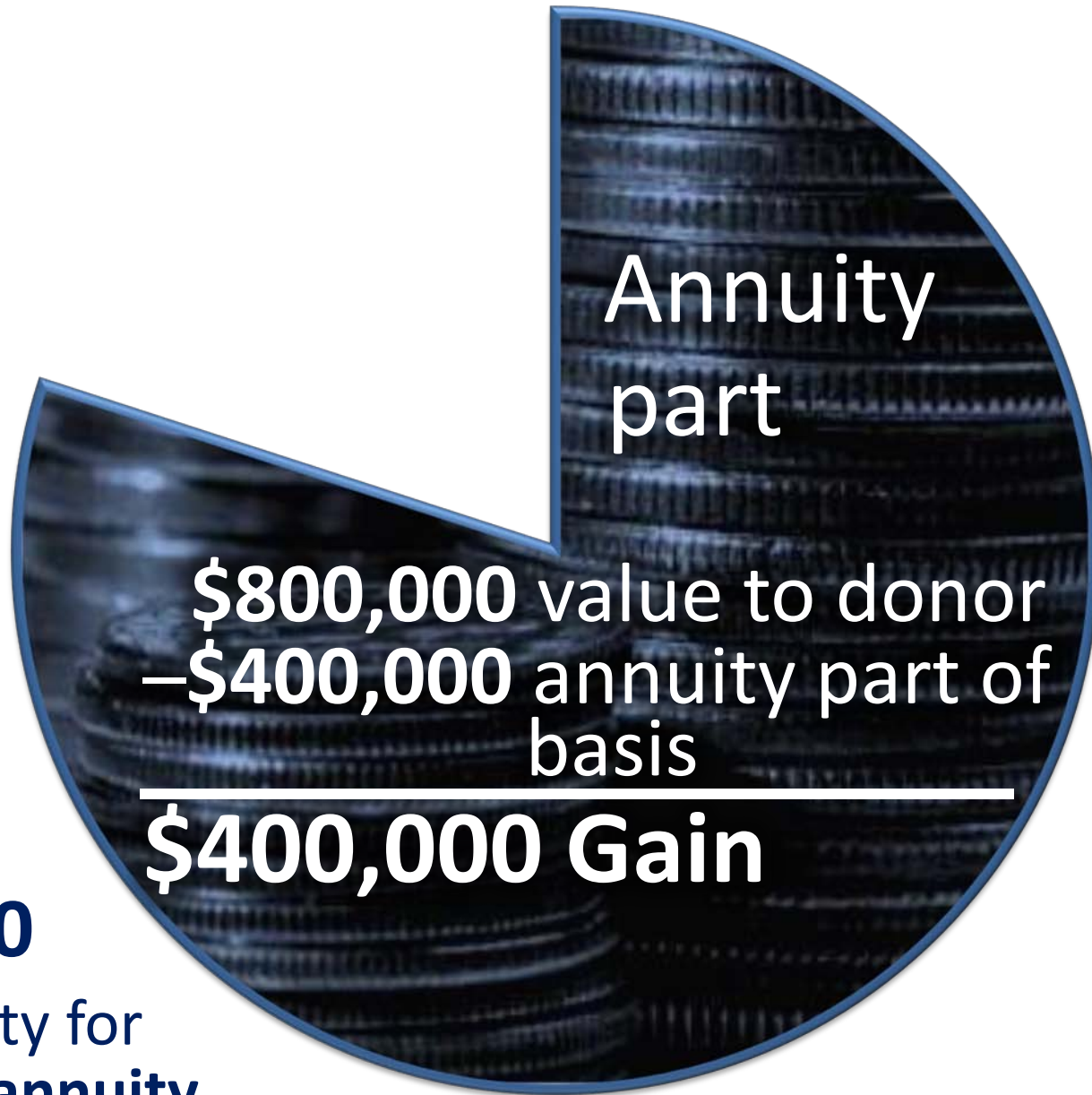
Original cost  
**\$500,000**

Value  
**\$1,000,000**

Gave to charity for  
**\$800,000 annuity**



# Gain: Annuity value less annuity part of basis



Annuity  
part

\$800,000 value to donor  
– \$400,000 annuity part of  
basis

---

**\$400,000 Gain**

Original cost  
**\$500,000**

Value  
**\$1,000,000**

Gave to charity for  
**\$800,000 annuity**



**If donor purchases annuity for another person with appreciated property, tax on capital gain is paid immediately**

**If donor is annuitant (or if jointly purchased annuity for donor and spouse), tax on capital gain is paid over life expectancy**





**Part of  
each  
year's  
payment  
is capital  
gain**

**Total capital gain**

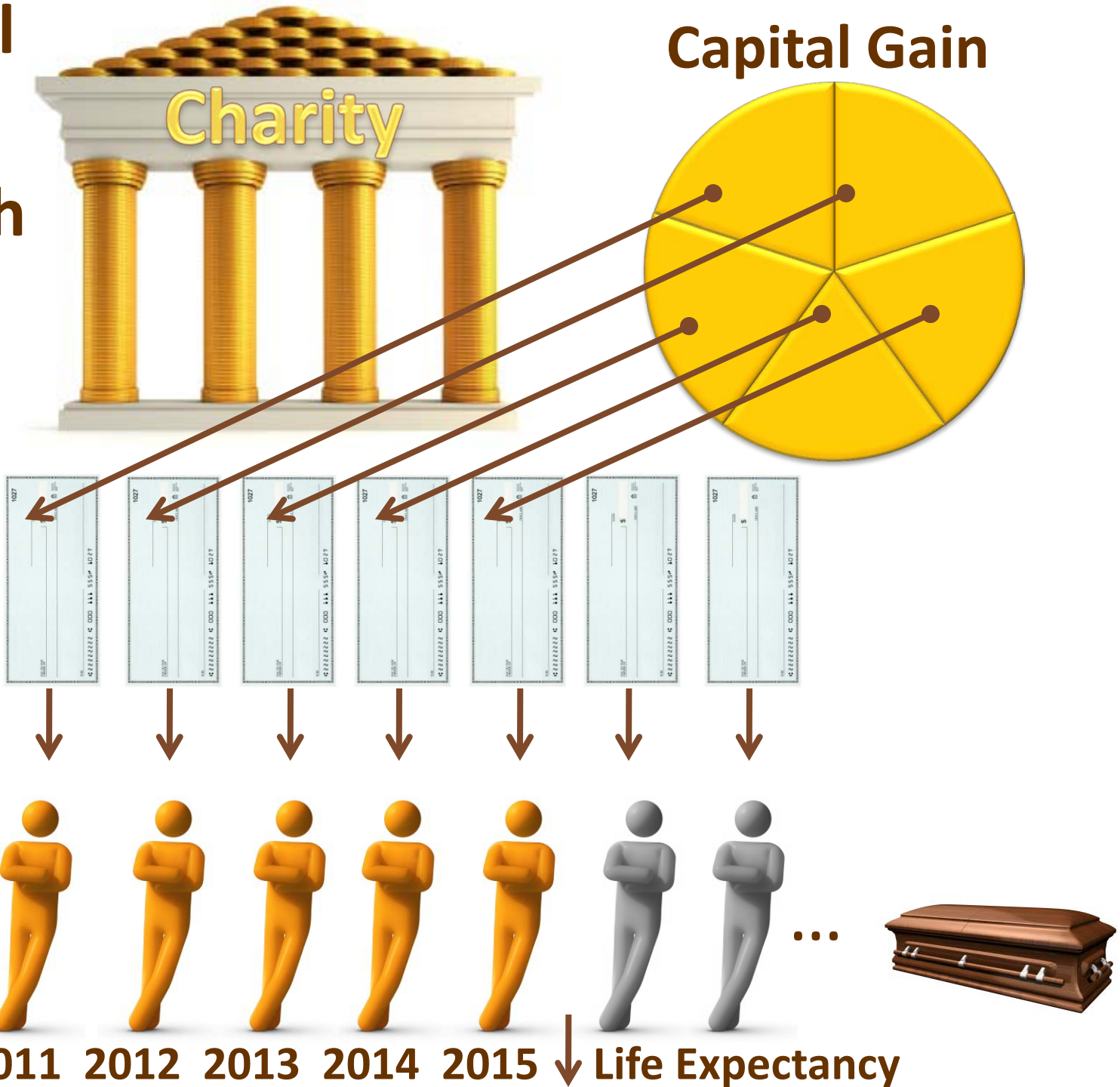
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**Original life expectancy**

Total capital gain is divided among each expected payment

Capital Gain

Charity



2010

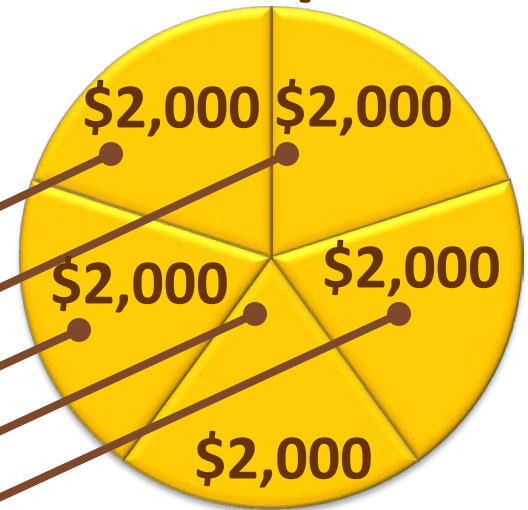
2011 2012 2013 2014 2015 ↓ Life Expectancy



5 year life expectancy and \$10,000 gain  $\rightarrow$  \$2,000 of each check for 5 years is capital gain



\$10,000 Capital Gain



...



2011 2012 2013 2014 2015  $\downarrow$  Life Expectancy

**How much of  
each \$5,000  
annuity payment  
is capital gain?**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**

**How much of  
each \$5,000  
annuity payment  
is capital gain?**

**Total capital gain  
Original life expectancy**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**



# How much of each \$5,000 annuity payment is capital gain?

How much is this?

Total capital gain  
Original life expectancy

21 years  
(previous slides)

Donor gives \$100,000 stock (cost \$50,000)



Annuity

\$5,000



Charity pays age 55 donor \$5,000 per year for life

**How much of  
each \$5,000  
annuity payment  
is capital gain?**

**Value of annuity  
- Basis used for sale part  
Total capital gain**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**

# How much of each \$5,000 annuity payment is capital gain?

**\$86,466**  
(previous slides)

**Value of annuity**  
**- Basis used for sale part**  
**Total capital gain**

**\$50,000 basis X**  
**(\$86,466/\$100,000)**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**

**Charity**  
**pays age**  
**55 donor**  
**\$5,000**  
**per year**  
**for life**

# How much of each \$5,000 annuity payment is capital gain?

**\$86,466**  
(previous slides)

**\$86,466 (Annuity)**  
**- \$43,233 (Basis used)**  

---

**Total capital gain**

**\$50,000 basis X**  
**(\$86,466/\$100,000)**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity**  
**pays age**  
**55 donor**  
**\$5,000**  
**per year**  
**for life**

**How much of  
each \$5,000  
annuity payment  
is capital gain?**

**\$86,466 (Annuity)**  
**- \$43,233 (Basis used)**  

---

**\$43,233 Capital Gain**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**



**How much of  
each \$5,000  
annuity payment  
is capital gain?**

**\$43,233  
Capital Gain**

**Total capital gain  
Original life expectancy**

**21 years  
(previous slides)**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**

# How much of each \$5,000 annuity payment is capital gain?

**\$43,233**  
**Capital Gain**

$$\frac{\$43,233}{21} = \$2,059$$

**21 years**  
(previous slides)

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

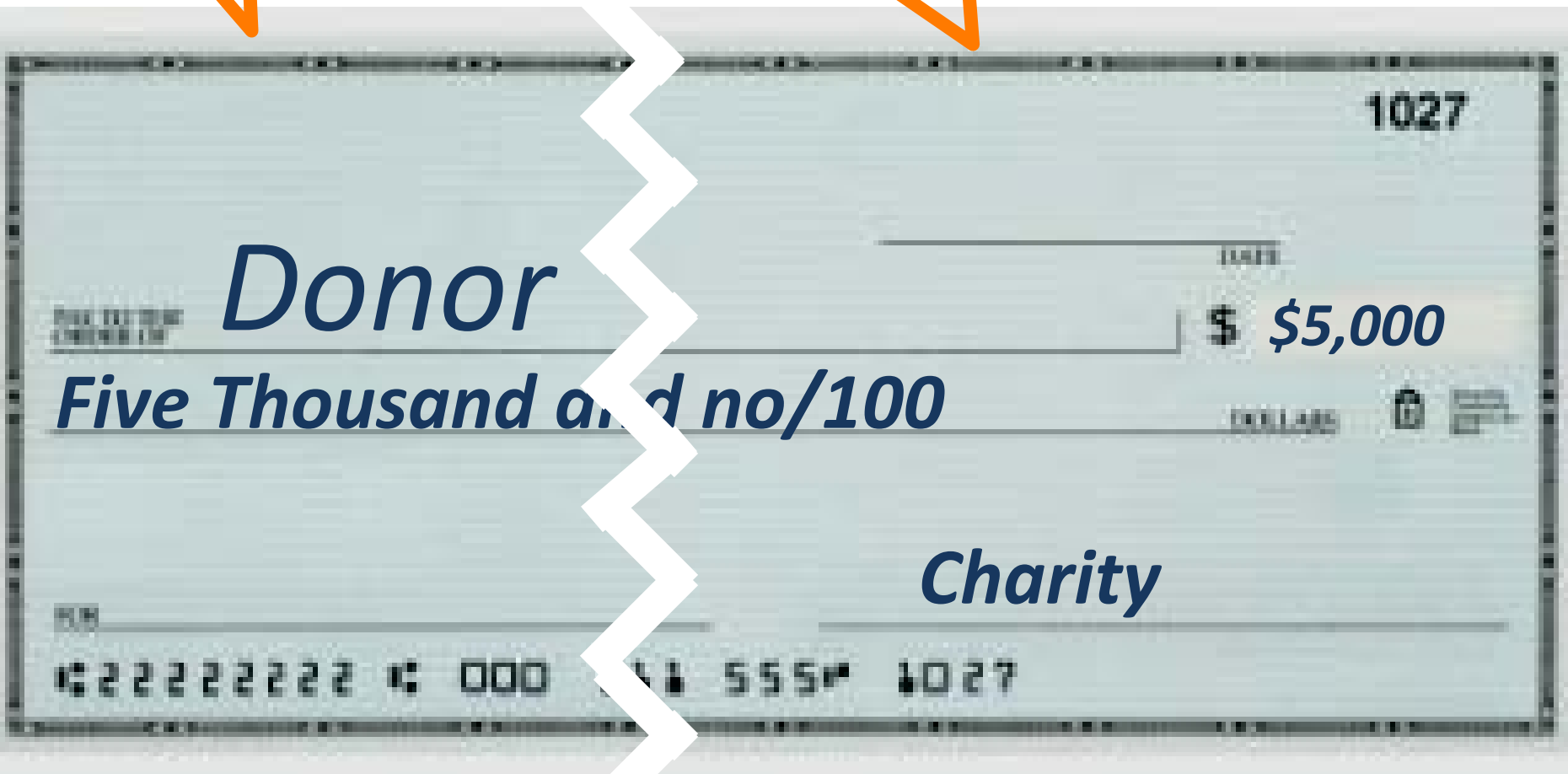
**\$5,000**



**Charity**  
**pays age**  
**55 donor**  
**\$5,000**  
**per year**  
**for life**

**\$2,059 is  
capital  
gain**

**How much is  
tax free return  
of investment?**





**How much of  
each \$5,000  
annuity payment  
is tax free return  
of investment?**

**Basis used for annuity  
Original life expectancy**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**



**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**

# How much of each \$5,000 annuity payment is tax free return of investment?

$\$50,000 \text{ basis} \times (\$86,466 / \$100,000)$

Basis used for annuity  
Original life expectancy

21 years  
(previous slides)

Donor gives \$100,000 stock (cost \$50,000)



Annuity

\$5,000



Charity pays age 55 donor \$5,000 per year for life

# How much of each \$5,000 annuity payment is tax free return of investment?

Donor gives \$100,000 stock (cost \$50,000)



$\$50,000 \text{ basis } \times (\$86,466 / \$100,000)$

$$\frac{\$43,233}{21} = \$2,059$$

21 years  
(previous slides)

Charity pays age 55 donor \$5,000 per year for life

Annuity



**\$5,000 Check**

**\$882 Ordinary  
Income**

**\$2,059  
Capital  
Gain**

**\$2,059  
Return of  
Basis**

**Donor gives \$100,000  
stock (cost \$50,000)**



**Annuity**

**\$5,000**

**Charity  
pays age  
55 donor  
\$5,000  
per year  
for life**



2010

1027 <b>\$822</b> Ordinary income <b>\$2,059</b> Cap Gain <b>\$2,059</b> Return of Basis	1027 <b>\$822</b> Ordinary income <b>\$2,059</b> Cap Gain <b>\$2,059</b> Return of Basis	1027 <b>\$822</b> Ordinary income <b>\$2,059</b> Cap Gain <b>\$2,059</b> Return of Basis	1027 <b>\$822</b> Ordinary income <b>\$2,059</b> Cap Gain <b>\$2,059</b> Return of Basis	1027 <b>\$5,000</b> Ordinary income	1027 <b>\$5,000</b> Ordinary income
--	--	--	--	--	--



2011



2012



2013 ...



2022



Life Expectancy



...



Death





2010

1027	<b>\$822</b>	1027	<b>\$822</b>	1027	<b>\$822</b>
Ordinary	Ordinary	Ordinary	Ordinary	Ordinary	Ordinary
income	income	income	income	income	income
<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>
Cap Gain	Cap Gain	Cap Gain	Cap Gain	Cap Gain	Cap Gain
<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>	<b>\$2,059</b>
Return	Return	Return	Return	Return	Return
of Basis	of Basis	of Basis	of Basis	of Basis	of Basis



2011



2012

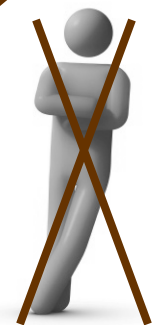


2013

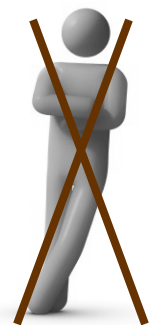
... Death...



If early death,  
donor's last tax  
return deducts  
allocated basis not  
yet given back



2022



Life Expectancy

Ordinary  
Income

Tax Free  
Return of  
Investment

Capital  
Gain

Gift Taxes



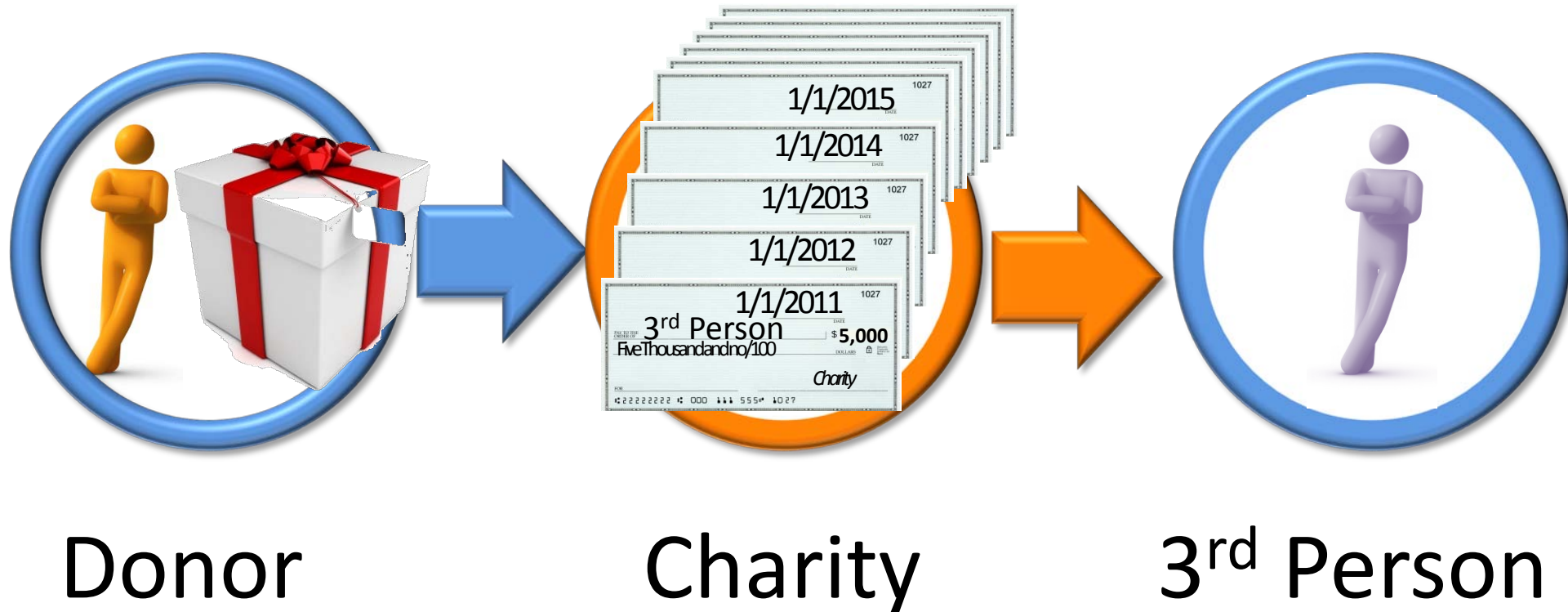
Charitable  
Deduction

Annuity

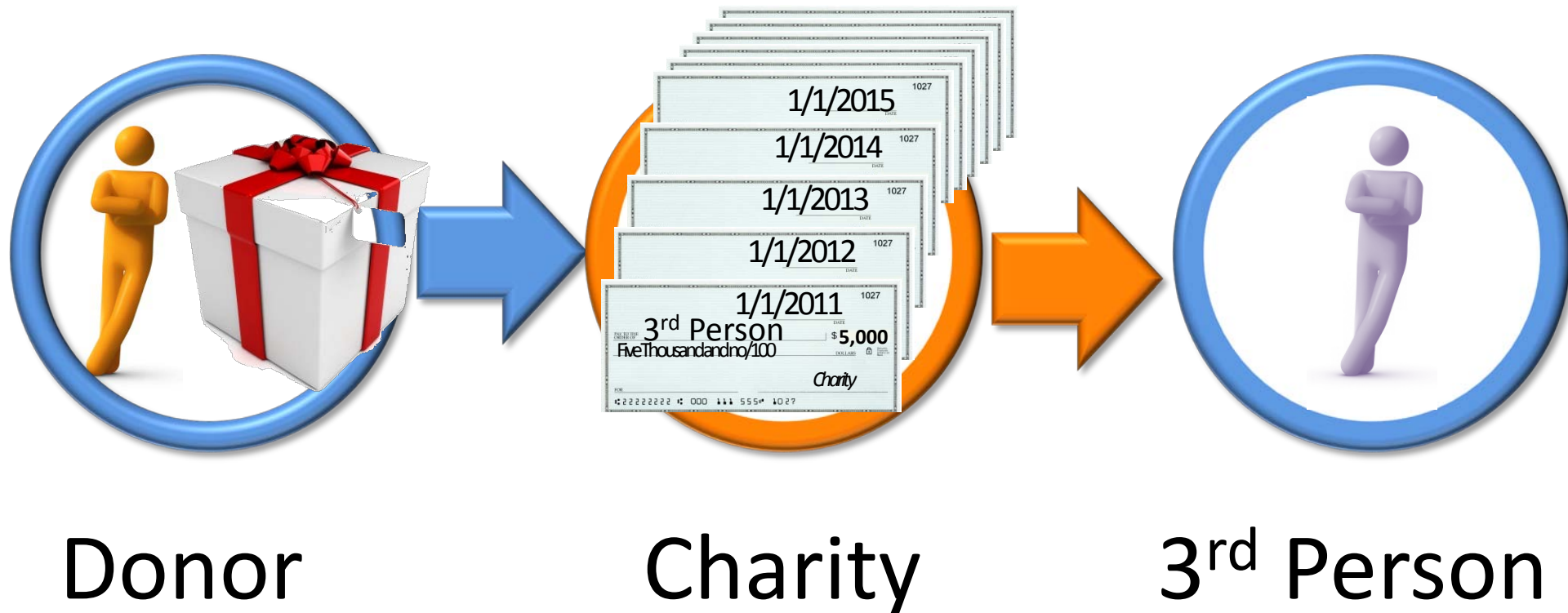




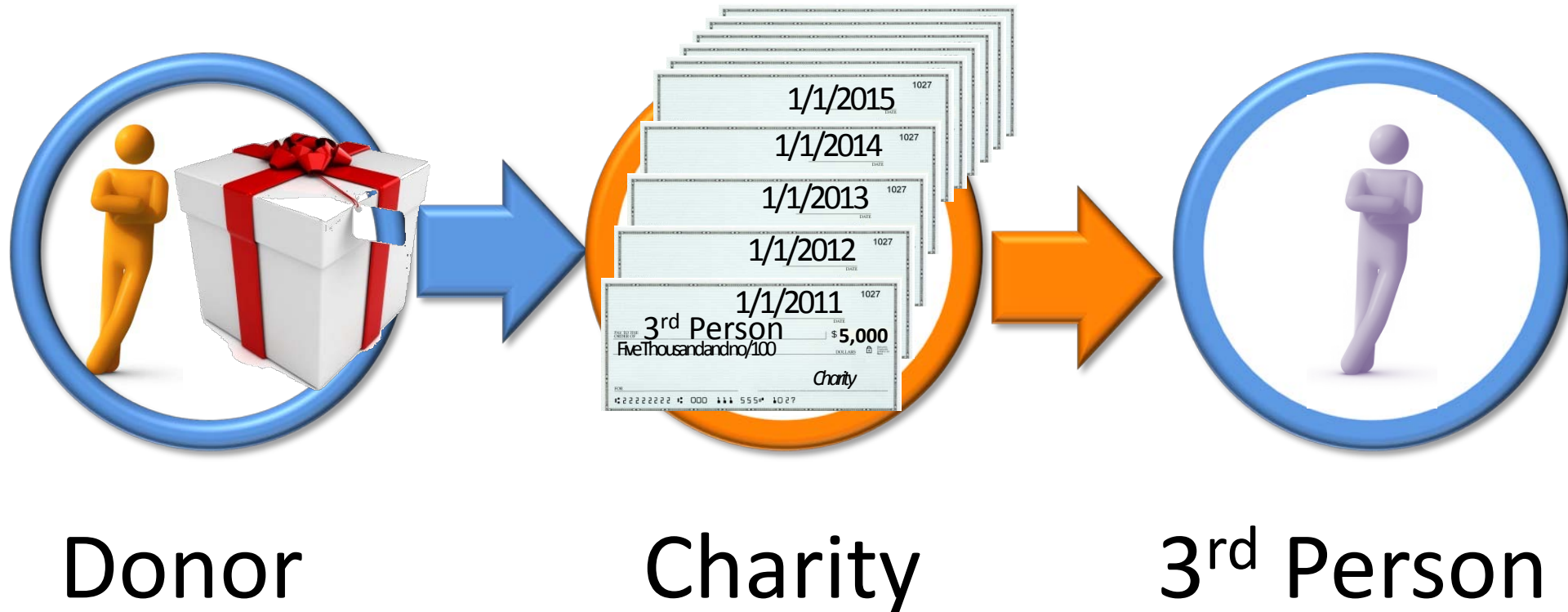
# If donor names a different annuitant, the donor has made a gift to that person



**This gift (to a non-spouse) may reduce the remaining \$1,000,000 gift tax exclusion**



The gift tax value of an **immediate** annuity can be reduced by the \$13,000/year present interest exclusion for gifts



**Ordinary  
Income**

**Tax Free  
Return of  
Investment**

**Capital  
Gain**

**Gift Taxes**



**Charitable  
Deduction**

**Annuity**



# Taxation of Charitable Gift Annuities



Pictures from [www.istockphoto.com](http://www.istockphoto.com)

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## About the Author

Russell James, J.D., Ph.D., CFP® is an Associate Professor and the Director of Graduate Studies in Charitable Planning in the Division of Personal Financial Planning at Texas Tech University. He graduated, *cum laude*, from the University of Missouri School of Law where he was a member of the Missouri Law Review. While in law school he received the United Missouri Bank Award for Most Outstanding Work in Gift and Estate Taxation and Planning and the American Jurisprudence Award for Most Outstanding Work in Federal Income Taxation. After graduation, he worked as the Director of Planned Giving for Central Christian College, Moberly, Missouri for six years and also built a successful law practice limited to estate and gift planning. He later served as president of the college for more than five years, where he had direct and

supervisory responsibility for all fundraising. Dr. James received his Ph.D. in Consumer & Family Economics from the University of Missouri where his dissertation was on the topic of charitable giving. Dr. James has over 100 publications in print or in press in academic journals, conference proceedings, professional periodicals, and books. He writes regularly for *Advancing Philanthropy*, the magazine of the Association of Fundraising Professionals. He has presented his research in the U.S. and across the world including as an invited speaker in Ireland, Scotland, England, The Netherlands, Spain, Germany, and South Korea. ([click here for complete CV](#))



Me (about 5 years ago)



Lecturing in Germany. 75 extra students showed up. I thought it was for me until I found out there was free beer afterwards.



At Giving Korea 2010. I didn't notice until later the projector was shining on my head (inter-cultural height problems).