

What's Hot In Charitable Planning?



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Charitable Split Interests

CLTs

- CLAT
- CLUT
- NIMCRUT

LEAs

CGAs

CRTs

- CRAT
- CRUT



Today's Agenda

How charitable vehicles are affected by interest rates, specifically the charitable federal mid-term rate (CFMR).

How charitable vehicles are affected by the net investment income tax (NIIT).



CFMR MARCH 2014

For purposes of determining the present value of an annuity, an interest for life or a term of years, or a remainder or a reversionary interest, the Treasury publishes a monthly Charitable Federal Midterm Rate as described under Code Section 7520. The taxpayer may elect to use the rate in effect for the month in which the transfer occurs or either of the two months preceding the transfer. The rate for the following month is published during the third week of each month.

Current Rates

March 2.2%

February 2.4%

January 2.2%



Best Vehicles With Low Rates

Two gift vehicles that provide donors with the highest deductions when the charitable midterm federal rates are low are:

- life estate agreements (LEA); and
- charitable lead trust (CLT).

Lower present value = higher charitable income deductions.



Charitable Lead Trust (CLT)

A CLT generally holds income producing property.

The trust is set up to pay income to charity for a period of years or the donor's lifetime, with individuals (non-charities) being the residuary owners of trust principal at termination.



CLATs and CLUTs

A charitable lead annuity trust (CLAT) pays a fixed annuity based upon the value of the donor's contribution at the time the trust is established.

The charitable lead unitrust (CLUT) makes distributions based upon the value of the trust assets as re-determined annually.



CLT: Grantor and Non-Grantor

A CLT can be a:

“grantor trust” which allows some portion of the trust assets to revert to the donor; or

“non-grantor” trust which transfers all remaining trust assets to a person other than the grantor.



CLT: The income tax deduction

Grantor CLT: Immediate charitable contribution deduction for the income interest, subject to applicable percentage limitations depending on whether a public charity or a private foundation is the beneficiary. Annual Income is taxable to the grantor during the term with no offsetting of future charitable deductions as the amounts are paid to the charity.

Non-grantor CLT: No immediate charitable contribution, but the income is taxable to the trust as earned --- the deduction to the trust for the charitable donation subject to the percent limitations.



CLT: Gift/ Estate/GST taxes

Non-grantor CLT:

- Living donor subject to gift tax on actuarial value of the remainder interest.
- Deceased donor subject to estate tax, but eligible for an estate tax deduction for the value of the interest passing to charity.
- If the remainder beneficiaries are/could be the donor's grandchildren, the distribution subject to GST unless the donor or the donor's estate is able to allocate the GST exemption to the transfer or bequest.



CLT: CFMR and Grantor vs. Non-Grantor

The CFMR affects the choice between grantor and non-grantor lead trusts.

In order for a tax deduction to be allowed for a grantor trust, at termination the trust must return more than 5% of the trust property to the grantor.

As the CFMR moves away from the annuity rate (lower), this can only be accomplished with shorter terms. Thus, to qualify the trust as a charitable trust, the donor must have a short life expectancy or choose a short term of years.



CLT: Candidates

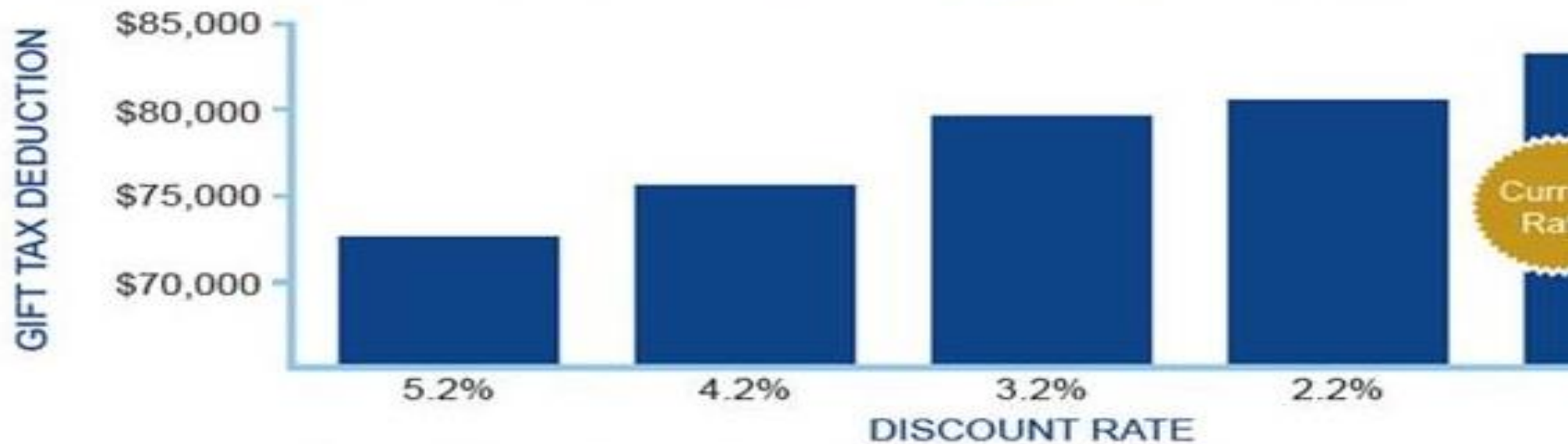
Grantor Trust: People seeking income tax deduction rather than estate tax deduction. A grantor trust might work particularly well for a client that has a large bonus in a specific year or is retiring or selling a business resulting in lower AGI in future years.

Non-Grantor Trusts: Clients that have assets expected to appreciate rapidly and/or looking for estate tax savings.



Charitable Lead Annuity Trust

The Lower the Discount Rate, the Higher Your Deduction*



*Example is for a 65-year-old creating a \$100,000 charitable lead annuity trust

CLUT and CFMR

The mid-term rate's effect on CLUTs is basically neutral.

With a CLUT, the CFMR is not the discount rate, the trust's **payout** rate is. Thus, it has little effect on the unitrust's deduction. However, a 1% difference in the **payout** rate can change the deduction by 6% of the gift.

If the trust makes one annual payment at the beginning of the year, there is no effect. The maximum effect is felt by CRUTs that have a greater time period between valuation and payout, but even this effect is negligible.



Charitable Remainder Trust

A Charitable Remainder Trust (CRT) is an irrevocable agreement to hold assets for a term.

- Life of Beneficiary or set period of time not to exceed 20 years.
- During the term of the CRT, the trustee will distribute either a fixed percentage or fixed dollar amount to a non-charitable beneficiary.
- At the end of the term, the CRT's remaining assets distributed to charity.



CRT: Annuity or Uni-trust

Annuity Trust = Fixed \$ distribution

Unitrust = Fixed % distribution

Choose:

- Annuity Trust for certainty
- Uni-trust participates in market volatility



CFMR and CRAT vs. CRUT

Interest Rate Affect:

- Charitable remainder annuity trusts (CRATs) are highly affected by the CFMR.
- Charitable remainder unitrusts (CRUTs) are barely affected.



CRAT and the CFMR

Lifetime Annuity trusts are subject to both the 5% and the 10% rules.

Must be less than a 5% probability that the trust assets will be exhausted prior to the end of the trust term (based upon the life expectancy tables) and the value of the remainder must be at least 10% of the initial contribution.



CRAT and the CFMR

Both tests are highly sensitive to the CFMR, also known as the §7520 Rate.

When interest rates are low it is likely that it will be necessary to use trust principal to make annuity payments to the donor (particularly over a longer term) which means that there is a greater chance of running out of assets, thus failing both tests.

To pass, especially with a longer term, the discount rate must approach less than a 1% difference from the payout rate.



Life Estate Agreements

The retained life estate is a gift of a personal residence or farm today while the donor retains the right to live there for the rest of his or her life. The residence does not have to be a principal residence; it can be a second home or vacation home.

The CFMR is used as the discount rate. The lower the rate, the less the discount and the higher the present value of the remainder interest (the charitable deduction).



Life Estate Agreements

Example:

John and Jane Smith, both 79, own a vacation condominium on the beach worth \$300,000. They would like to give it to a charitable organization now, yet retain a life estate.

- 1% CMFR the income tax charitable deduction = \$213,416
- 3% CMFR the deduction = \$172,000



Life Estate Example

A person aged 60 donates to Charity a remainder interest in her personal residence reserving a life estate.

Value: \$250,000/Useful life: 45 years/Residual value: \$10,000

At 8.6% interest rate the present value of remainder is \$48,479.70

At 3.6%, the present value of the remainder is \$89,808.00.

Low interest rates = better tax deduction



Charitable Gift Annuities

A charitable gift annuity is a simple contract between a donor and a charity, whereby the charity agrees to pay a fixed annuity to a donor, his or her spouse, or a third party for life, in exchange for an irrevocable gift of cash or property.

To provide for a gift component to the charity issuing the annuity, rates are lower than those available from commercial insurance carriers, with the purchase of the annuity generally resulting in an immediate charitable income tax deduction of approximately 50% of the annuity purchase price.



Low Interest Rates

HOT

- Lead Trust
- Life Estates

NOT

- CGA
- Remainder Annuity Trust

BUT...



Net Investment Income Tax

The Net Investment Income Tax is imposed by section 1411 of the Internal Revenue Code. The NIIT applies at a rate of 3.8% to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts.

Filing Status	Threshold
Married filing jointly	\$250,000
Married filing separately	\$125,000
Single	\$200,000
Head of household (with qualifying person)	\$200,000
Qualifying widower with dependent child	\$200,000



NIIT on Trusts

Estates and trusts are subject to the Net Investment Income Tax if they have undistributed Net Investment Income and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year under section 1(e) .

2014 threshold amount is \$12,150 (See Rev. Proc. 2013-35).



What is included in NIIT?

In general, investment income includes, but is not limited to:

interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer (within the meaning of section 469).



Trusts not subject to the NIIT

- Trusts exempt from income taxes imposed by Subtitle A of the Internal Revenue Code (e.g., charitable trusts and qualified retirement plan trusts exempt from tax under section 501 and Charitable Remainder Trusts exempt from tax under section 664).

- A trust or decedent's estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B).



CRT and NIIT

A CRT can be particularly useful in planning to avoid the impact of the tax on NII under Section 1411 assuming, of course, that the taxpayer is willing to give the remainder interest in the trust to charity.

Eligible charities include the taxpayer's own private foundation, a donor-advised fund sponsored by a public charity, or a public charity.

CRTs are not subject to the NII tax under Section 1411.62 Therefore, similar to the income tax context, a taxpayer can transfer substantially appreciated property to a CRT that can then be sold by the CRT free of any Section 1411 tax.



CRT and NIIT

CRT is exempt from NIIT, but the annuity and uni-trust distributions by a CRT carry out NIIT to the individual non-charitable beneficiaries.

Smooths out over a period of years the NIIT carried out to beneficiaries on a year-to-year basis and subjects the taxation of such NII to the higher thresholds applicable to individuals.

Minimizes (or at least defers) the NIIT earned by the CRT.



Four Tier Tax Plus NIIT

While the CRT itself is exempt from income tax, the annual annuity or uni-trust payments carry out income to the non-charitable beneficiary or beneficiaries based on specified ordering rules under a special four-tier system, generally treating the most highly taxed income of the trust as being distributed first.⁵⁷ Under these ordering rules, the annuity or uni-trust payments carry out income from the CRT in the following order:

- (1) From ordinary income.
- (2) From capital gain income.
- (3) From other income, including tax-exempt income.
- (4) As a tax-free return of principal.⁵⁸



NIIT Comes First

Current and accumulated net investment income of the trust is deemed to be distributed before amounts that are not items of net investment income for purposes of Sec. 1411.

Classification of income as net investment income or non-net investment income is separate from, and in addition to, the four tiers under Sec. 664(b).

Trustees of charitable remainder trusts must keep track of an entire new classification of income, namely, current and accumulated net investment income. In addition, distributions of current and accumulated net investment income to beneficiaries will need to be reported to the beneficiary on his or her Schedule K-1 (Form 1041)



Example: CRT and NIIT

A, a single taxpayer, has a salary of \$150,000 and no other income. If A were to sell long-term capital gain property at a gain of \$350,000, her NII and AGI would be \$350,000 and \$500,000, respectively. A would have \$300,000 of NII subject to the Section 1411 tax—the lesser of (1) the NII of \$350,000 and (2) \$300,000, the excess of the \$500,000 of AGI over the \$200,000 threshold amount.

If A contributed the property to a CRT which then sold the property, the \$350,000 gain would not be subject to the Section 1411 tax or the regular income tax. If the annual payment were \$50,000 for a particular year and the payment consisted of only long-term capital gain, then A would be considered to realize long-term capital gain income from the CRT of \$50,000. In such a case, A's NII and AGI would be equal to \$50,000 and \$200,000, respectively.

Because A's AGI would not exceed the \$200,000 threshold, A would not be subject to any tax under Section 1411.



NIIT and Non-Grantor CLT

Non-grantor CLTs are subject to the 3.8% tax under Section 1411.

Consistent with the treatment of a taxable trust, a CLT is allowed a deduction for that portion of its NII that is allocated to amounts allowable as a charitable deduction under Section 642(c).

As a result, the Section 642(c) charitable deduction available to a CLT effectively shifts NII away from the CLT (and, therefore, reduces its undistributed NII) and into the hands of a tax-exempt beneficiary that is not subject to the Section 1411 tax.



Outright Gifts To Charity

A charitable contribution of NII-producing property to a tax-exempt organization described in Section 501(c)(3) 78 shifts the NII associated with such property to the donee charity, thereby exempting such NII from tax under Section 1411.79

Donors wishing to retain control over their charitable contributions (rather than making an unrestricted gift) can make the contribution to a donor's private foundation or a donor-advised fund maintained by a public charity with respect to which the donor is an advisor.

Current income tax deduction, but “delayed” use.



NIIT and Charitable Gift Annuities

Similar to a CRT, CGAs may avoid the immediate imposition of capital gain tax on the sale of substantially appreciated property and stretch out NII over a multiple years.

The annuitant is generally allowed to exclude from income a predetermined portion of each annuity payment as a tax-free return of the “investment in the contract” until the amount is fully repaid. Thus, if the charitable gift annuity is funded with cash, the annuity payment consists of two components:

- (1) A tax-free return of principal;
- (2) Ordinary income.



NIIT and Charitable Gift Annuities

If not cash then: Annuity payments considered NII (other than the portion of the annuity payment considered to be a tax-free return of principal),

But, like CRT --- reported as received.

Thus, as in the case of a CRT, depending on the annuitant's NII and AGI, the purchase of a CGA in exchange for appreciated property may eliminate or reduce the Section 1411 tax or, at a minimum, defer the imposition of such tax.



NIIT and Grantor CLT

A grantor CLT itself is not subject to Section 1411.

However, consistent with the grantor trust rules, any NII earned by the trust is taxable to the settlor, which is not offset to any extent by the annuity or uni-trust payments made to charity from the CLT.

Grantor CLT not particularly useful in planning for the Section 1411 tax.



NIIT and Private Foundations/DAFs

A private foundation, but not a donor-advised fund, is subject to a special excise tax on NII under Section 4940.

Investment income attributable to contributed property subjects the foundation to either a 2% or 1% tax, thereby reducing the benefit otherwise realized by avoiding the 3.8% tax by contributing the property to a private foundation.

Consider restricted gift to public charity instead.



Side Note: Trusts Distributing Gross Income to Charity

A charitable contribution by a trust under Section 642(c) shifts NII to a charity, reducing the Section 1411 tax that would otherwise be imposed on the trust.

As a result, from a Section 1411 tax perspective, it is advantageous for an individual to fund charitable contributions from a trust as opposed to making direct charitable contributions.

A Section 642(c) deduction is not available unless the trust document specifically provides for the distributions of gross income of the trust to charity, which include discretionary distributions to charity by the trustee.



NIIT

Hot

- Lead Trust
- CRAT
- Life Estates



State Income Tax on Trusts: Introduction

Most states impose an income tax on trusts.

The tax ranges from 3% to over 12%.

With planning the tax may be reduced or avoided, conversely without planning a trust may be subject to tax in more than one state.



The Benefit to the Client

Elimination of the state income tax can improve a trust's real investment performance by over 100 basis points a year simply by eliminating the drag from state taxes.

Seven States have no income taxes, including Florida.



Bases for Taxation of Trusts

The 44 states that tax trusts on income do so on based upon the following:

- Trust created by Will of resident decedent
- If settlor of *inter vivos* trust lived in the state
- If the trust is administered in the state
- If one or more trustees live or do business in the state
- If one or more beneficiaries live in the state



Recent Illinois Case

Linn v. Department of Revenue

The trust was established in 1961 by A.N. Pritzker, an Illinois resident. The trust was initially administered by Illinois trustees pursuant to Illinois law. By 2006 the trust had been modified and relocated to Texas and had no trustee, beneficiary or asset in the state of Illinois.

The Illinois Department of Revenue (“IDR”) determined that the trust was a resident trust and was subject to Illinois income tax. The trustee argued that imposing Illinois tax under these circumstances was unconstitutional.



Opportunity: Reverse Grantor Trust

In PLR 201310002 the IRS agreed that the trust provisions and the applicable state law also meant that the accumulated trust income would no longer belong (be taxed to) the grantor.

This means that a grantor living in the state of New York can avoid the 12% plus state income tax.



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Janet Bandera is a nationally recognized attorney, author, lecturer and teacher. Janet has been engaged in the practice of law working with clients on estate and business planning for 18 years. She is an adjunct professor at Washington University School of Law and has been designated as AV Preeminent[®] and a 5 Star Wealth Manager[®].

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