Trusts and Estates

Opportunities for Year-End Charitable Giving Revisited

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We thought it would be worthwhile to remind our readers about opportunities for year-end charitable giving that allow tax deductions to be generated this year, but postpone the decision-making about actual charitable recipients for later years. Although charitable gifts can be made throughout the year, the end of the year is a popular time for donors to make final charitable giving decisions. This is mainly because it's the last opportunity to generate an income tax deduction for the year through a charitable gift. But, it's also because business affairs tend to slow down and donors of the greatest giving capability have time to reflect on more personal matters, which include fulfilling charitable objectives. Of course, in many cases, another factor is that it's the only time of the year for many taxpayers to have a handle on the amount of surplus funds they have available for charitable giving after assessing their net income and expenditures for the year.

For people who have had a particularly high-income year (such as may be the case when a donor's business has had a particularly successful year, or, perhaps, due to a scheduled Roth IRA conversion), it may be an ideal time to front-load gifts for future years. Such foresight allows a taxpayer to benefit in the current year from an income tax deduction attributable to the charitable contributions to be deployed further down the road. This can be accomplished in a number of ways—such as through a contribution to a donor-advised fund, a private foundation, a charitable remainder trust, a charitable lead trust or even a gift of a remainder interest in a house. In considering such potential gifts, donors should check with their tax advisers (or run the numbers themselves) to understand how the potential phaseout of their itemized deductions, based on a donor's income tax bracket, as well as general adjusted gross income limitations for charitable contributions, might impact the charitable deduction available for 2014. To the extent a deduction for charitable contributions might be limited in any particular year, generally the nondeductible amount will be available for use over the next five years as a "carry forward" item.

The current historically low-interest-rate environment favors gifts of remainder interests in homes and charitable lead trusts. For gifts made in December, the applicable federal rate (AFR) under Internal Revenue Code Section 7520 for such gifts is 2 percent (as was the case last December as well). By comparison, over the last 25 years, the AFR has ranged between 1 percent and 11.6 percent (most recently in January 2013 and May 1989, respectively).

The charitable deduction attributable to the gift of a remainder interest in a donor's home, which passes to the designated charity upon the donor's death, is calculated based on the age of the donor, the current AFR, and the current value of a home. For a home worth $1 million, a 60-year-old can generate a current charitable deduction of $665,340—by contrast, if the AFR were at 8 percent rather than 2 percent, the deduction would only be $253,800. The older the donor, the higher the deduction that can be generated.

A charitable lead trust involves a gift to a trust from which a set amount (annuity) or percentage of trust assets as redetermined annually (unitrust) must be distributed to one or more charities for a set number of years (or for the lifetime of the donor or another individual) after which the remainder passes to other beneficiaries (typically descendants of the donor). Such trusts can be structured to generate a current income tax deduction, but, then, the taxable attributes of the trust in subsequent years will be assigned to the donor through a "grantor trust" structure. Oftentimes, charitable lead trusts are structured instead as "non-grantor" trusts, which do not generate an income tax deduction in the first year, but, during the trust term, all of the taxable income of the trust may, in effect, be exempt from income tax due to distributions to charity. This structure is favored by active donors who are contributing more than they can currently deduct for income tax purposes due to the adjusted gross income deduction limitations and itemized deduction phaseout. From a federal gift and estate tax standpoint, the current low-interest-rate environment provides an ideal opportunity for a charitably minded client to establish a charitable lead annuity trust (CLAT). A popular structure is to "zero out" the trust for gift tax purposes, so that the value passing to the noncharitable beneficiaries at the end of the charitable term is worth nothing (i.e., "zero") for federal gift tax purposes. For a CLAT with a 20-year term, a 6.116 percent annuity payout is sufficient to zero it out while the AFR is 2 percent. To illustrate this, if the trust is funded with $1 million, a distribution of $61,160 must be made to charities each year from the trust. Whatever asset balance remains at the end of the term will pass free of gift and estate tax to the donor's beneficiaries. If the trust assets grow by 7 percent per year, about $1.36 million will be left for the noncharitable beneficiaries, or if instead the annual rate of return is only 6 percent, $957,328 would be left—free of federal gift or estate tax.

Similar to a gift of a remainder interest in a home, a charitable remainder trust (CRT) allows a donor to generate an income tax charitable deduction in the present year for a gift that is not scheduled to be delivered to the charity until the donor's death (or after a term of years or the death of a named third party). The present value of the charity's interest must be at least 10 percent of the property used to fund the CRT. The donor (and/or a third party) retains an interest structured as either an annuity or a unitrust. In today's low-interest environment, the unitrust is generally a more attractive option than an annuity, but, oftentimes donors like to hedge their bets by creating one of each type of trust. In addition to generating a current income tax deduction based on the present value of the remainder interest passing to charity, the CRT creates a tax shelter of sorts for capital gains. The income tax on capital gains realized by the CRT is exempt from income tax until it is distributed to the donor (or another noncharitable trust beneficiary). So, in some cases, all or a portion of the gain may never be subject to tax, and in other cases, the tax is deferred for a number of years. A CRT is a popular device for charitably inclined individuals to diversify their investment base while minimizing the diminishment in their investable assets due to the taxation of realized gain. It also allows donors to generate a current income tax deduction for a gift that they had intended to make to charity at death anyway.

Direct gifts to private foundations and donor-advised funds are appropriate for donors who are comfortable completely parting with the gifted assets without retaining any specified continuing economic rights to the assets. Donor-advised funds are the simplest approach for generating a current charitable deduction while deferring the decision as to which charities to benefit until a later date. Private foundations involve a bit more heavy lifting, but allow the donor to retain complete control over the charitable entity, similar to a wholly owned business enterprise. Many donors find it appealing that such control includes the opportunity to periodically pay "reasonable compensation" to the donor or family members from the foundation's resources for managing the foundation's activities. •

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