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Trusts and Estates

Revisiting Popular Year-End Deferred Charitable Giving Options

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We thought it would be worthwhile to remind our readers about popular approaches for significant year-end charitable giving. In particular, this article will review various charitable planning techniques whereby valuable income tax deductions can be generated currently, but the distributions to charitable recipients, and the decision making about which charitable recipients will benefit, may be postponed to 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. Also, as the holiday season gets underway, business affairs tend to slow down thereby providing some donors with the greatest giving capability extra 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 folks 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 frontload 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 phase out of their itemized deductions, based on a donor's income tax bracket, as well as general AGI limitations for charitable contributions, might impact the charitable deduction available for 2017. 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 5 years as a "carry forward" item.

The current historically low interest rate environment continues to favor gifts of remainder interests in homes and charitable lead trusts. For gifts made in September 2017, the applicable federal rate (AFR) under Internal Revenue Code Section 7520 (the 7520 rate) for such gifts is 2.4 percent. 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). For those who wish to take advantage of the low interest rate opportunities, it's important to note that we may be moving away from them going forward. We have already seen an increase of 1.0 percent since last September when the 7520 rate was 1.4 percent.

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 $616,650—by contrast, if the AFR were at 8 percent rather than 2.4 percent, the deduction would only be $253,800. That is because the lower the AFR is, the higher the charitable deduction will be for a charitable gift of a remainder interest. Also, the older the donor is, the higher the deduction that can be generated will be.

A charitable lead trust (CLT) involves a gift to a trust from which a set amount (annuity) (a CLAT) or percentage of trust assets as redetermined annually (unitrust) (a CLUT) 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 noncharitable beneficiaries (typically descendants of the donor). Although the donor may not retain the right to change the charitable beneficiaries in a CLT, the trust may be drafted in such a way to allow someone else to change the charitable beneficiaries each year, if advisable.

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 "nongrantor" 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 AGI deduction limitations and itemized deduction phase-out.

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 6.355 percent annuity payout is sufficient to zero it out while the AFR is 2.4 percent. This means that if the trust is funded with $1 million, a distribution of $63,550 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 noncharitable beneficiaries. If the trust assets grow by 7 percent per year, $1,264,421 will be left for the noncharitable beneficiaries, or if instead the annual rate of return is only 6 percent, $869,411 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). Unlike with a CLT, for a CRT, the donor can retain the right to change the designation of the charitable remainder beneficiaries at any time. The present value of the charity's interest must be at least 10% 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 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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