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How a Low Applicable Federal Rate Affects Charitable Giving

The Applicable Federal Rate (AFR) is the monthly interest rate used to calculate the charitable deduction for split-interest gifts. In January 2009, the AFR dropped to an historic low of 2.4% – a rate substantially below the previous historic low AFR of 3.0% posted in July 2003.

A low AFR creates opportunities for donors and presents certain challenges for professional advisors. In this issue, we review the advantages a low AFR creates for donors and discuss how you can help your clients avoid some potential pitfalls.

THE PURPOSE OF THE AFR

The AFR is necessary to calculate the time-value-of-money component of partial interests in property. At one time, the AFR was a fixed rate (6%, 10%). However, as interest rates fluctuated, the fixed AFR stood in stark contrast to economic realities. At times, advantage could be gained by exploiting the difference between the government's interest rate assumption and real-world interest rates. Eventually, Congress determined that the AFR would be a floating interest rate (effective May 1, 1989). The IRS publishes the AFR each month (for the following month).

A charitable gift of a partial interest – charitable remainder trust, charitable gift annuity, charitable lead trust, etc. – requires an AFR calculation. The particular rate needed to calculate the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest is 120% of the applicable federal midterm rate, rounded to the nearest two-tenths of one percent [IRC Sec. 7520].

WHY A FLOATING AFR?

As noted, the purpose behind a floating AFR was to prevent taxpayers from taking advantage of the difference between the government's interest rate assumption and real-world interest rates. The difference was quite dramatic under the fixed-rate system, which allowed taxpayers to time their transfers to derive greater tax benefits than the underlying economic realities supported.

Of course, the floating AFR is "locked in" at the time the gift is made. Subsequent changes in the interest rate have no effect on the charitable deduction determined at the time of the gift – no matter how much the later AFRs may change from the interest rate environment at the time of the gift. The only time subsequent AFRs become important is when the original gift is modified in some permissible way – such as relinquishing a life income interest in a charitable remainder trust in favor of the charitable remainderman. In this situation, the AFR at the time of relinquishment is used to value the second gift.

SELECTING THE OPTIMAL AFR

Donors may choose among AFRs in calculating the charitable deduction for a particular split-interest gift.

- AFR for the month of the contribution,
- AFR for the month prior to the month of the contribution, or
- AFR for the second month prior to the month of the contribution

Note: It is important not to simply "plug-in" the AFR prevailing in the month the gift is made. When preparing illustrations for clients, a separate illustration can be made for each of the available AFRs.

Moreover, since the AFR for next month is usually released by the 20th or so of the current month, there is really an "unofficial" fourth option: a donor can wait until next month to make the gift if he or she decides the forthcoming AFR is more favorable than the three standing options.

GENERAL RECOMMENDATIONS

Select the highest available AFR for:

- A charitable remainder trust (annuity trust or any type of unitrust)
- A charitable gift annuity (for highest charitable deduction – but see below)

- The relinquishment of a life estate in a personal residence or farm (the remainder interest having previously been given to charity)

Select the lowest available AFR for:

- A charitable lead trust (annuity trust or unitrust)
- The gift of a remainder interest in a personal residence or farm
- A charitable gift annuity (for highest income-tax-free payments, especially if the donor does not itemize and cannot use the charitable deduction)
- The relinquishment of an income interest in a charitable remainder trust

OPPORTUNITIES CREATED BY LOW AFRS

Gift Annuities for Non-itemizers

Though a low AFR will lower the potential income tax charitable deduction for charitable gift annuities, a low AFR means a higher income-tax-free portion of the annuity payments. And if a taxpayer is unable to itemize deductions, he or she may be very interested in establishing a gift annuity in a month when the AFR is relatively low in order to receive a larger portion of the annuity payments income-tax-free (as a recovery of principal) during his or her remaining life expectancy.

Here is an example: Helen (age 75) decided to give $50,000 in cash to her favorite qualified charity in return for a charitable gift annuity with a payout rate of 6.7% (the current American Council on Gift Annuities suggested rate for a single-life gift annuity). Under the IRS tables, Helen has a life expectancy of 13.4 years.

Selected AFR of 4%

Annual Payout:	$3,350
Charitable Deduction:	$22,482
Tax-Free Portion of the Payout:	$2,294.75

Selected AFR of 7%

Annual Payout:	$3,350
Charitable Deduction:	$27,161
Tax-Free Portion of the Payout:	$1,902.80

Note that all income from the charitable gift annuity will be ordinary income after Helen reaches her life expectancy. But, during that time, Helen would receive about 20% more of her payout as tax-free under the 4% AFR scenario as compared to the 7% AFR scenario.

Grantor Charitable Lead Trusts

A trust that pays income to a charity for a period of years and then the corpus reverts to the grantor is a "grantor CLT" [IRC Sec. 170(f)(2)(B)]. The grantor is taxed on trust income but receives a first-year income tax deduction (subject to the percentage-of-AGI limitations) for the present value of the charity's interest. A low AFR will reduce the present value of the grantor's reversionary interest and, conversely, increase the grantor's deduction for the charitable income interest.

Suppose the grantor funds a CLT with highly appreciated or high-dividend-paying stocks or both. Under current law, qualified dividends collected by the trustee and long-term capital gains on the sale of appreciated stock will be taxed to the grantor at a 15% rate (for taxpayers in the 25% marginal tax bracket and above) in the years received or realized. These dividends and gains can be used to make the charitable income payouts. Meanwhile, the grantor enjoys an upfront deduction for the (AFR-boosted) charitable income interest in a tax bracket that could be as high as 35%. Save taxes today at 35%, pay taxes tomorrow at 15%(if the long-term capital gains tax rate and ordinary income tax rates remain constant).

Non-Grantor Charitable Lead Trusts

In a non-grantor CLT, the trust corpus is distributed to family members or other third parties when the charitable income interest ends (rather than reverting to the grantor). A low AFR increases the present value of the charity's expected income interest which increases the gift or estate tax charitable deduction and reduces the value of the remainder interest used to calculate federal transfer taxes. Moreover, if the trust corpus appreciates during the trust term, the appreciation escapes transfer taxation when it ultimately passes to family members.

An elderly grantor with philanthropic interests might want to use the non-grantor CLT as an estate distribution device. The grantor could use the currently low AFR, while selecting a trust term and payout percentage that dramatically "discount" the taxable value of the ultimate transfer to family members. The gift tax ($1 million) or estate tax exemption ($3.5 million in 2009) can be used to reduce or eliminate transfer tax. The general plan is to gain leverage when the assets used to fund the CLT are expected to increase at an annual rate greater than the AFR.

Remainder Interests in Personal Residences and Farms

An important exception to the partial-interest rule allows donors to claim a charitable deduction for outright gifts of remainder interests in personal residences and farms [IRC Sec. 170(f)(3)(B)(i)]. The donor retains a life estate that gives him or her use and occupancy of the property for life (or joint lives). The personal residence does not have to be a principal residence; it can be a second home or vacation home. A charitable gift of the remainder interest

of property located in a state other than the donor's own domicile can eliminate the need for ancillary administration upon the donor's death.

When AFRs are low, the present value of a charity's remainder interest is discounted in small increments for each year of the donor's remaining life expectancy. The charitable deduction for the gift might be spread over several years (because the percentage-of-AGI limitation caps the annual deduction) and substantially reduce the donor's income tax bill in those years.

If at a later time the donor wants to move to a retirement community or needs to move to a nursing home or an assisted living facility, and the retained life estate no longer provides value to the donor, he or she could transfer the life estate to the charity. Upon making the transfer, the donor could take a charitable deduction for the remaining value of the life estate. The AFR in effect at the time of the second transfer will be the basis for valuing the donor's life estate as a charitable gift.

PROBLEMS POSED BY LOW AFRS – CHARITABLE REMAINDER ANNUITY TRUSTS

Newly Created Inter Vivos Charitable Remainder Annuity Trusts

Charitable remainder trusts (CRTs) are required to provide a charitable remainder interest of no less than 10% of the value of the assets transferred when they are established [IRC Sec. 664(d)(1)(D) for annuity trusts and 664(d)(2)(D) for unitrusts]. This is in addition to the requirement that the possibility for exhausting the CRT assets cannot be more than a 5% probability at the time of trust creation [Rev. Rul. 77-374, 1977-2 C.B. 329; see also Ltr. Rul. 8152019]. In a time of low AFRs, this can prove difficult.

But an attorney can anticipate these problems and design an inter vivos Charitable Remainder Annuity Trust (CRAT) to meet both the 10% and 5% tests. For instance, the attorney may need to:

(1) Reduce the payout percentage lower than what was initially desired,

(2) Shorten the trust period to a term of years rather than life, especially if the income beneficiary is relatively young,

(3) Select an older income beneficiary, or

(4) Eliminate a second income beneficiary.

Taking any one of these actions reduces the present value of the income interest and boosts the present value of the charitable remainder interest.

Existing Charitable Remainder Annuity Trusts

When interest rates are high, a donor might establish a charitable remainder trust with a high payout rate (8-12%). However, if a CRT is unable to earn an investment return that keeps pace with the payout rate, the trustee will begin to invade principal to make the required payouts. Particularly with CRATs, where the payout amount remains fixed even when the principal is shrinking, the trust corpus may be in jeopardy of exhaustion.

Suppose this scenario begins to play out in an existing CRAT. What can be done? The income beneficiary could assign the remaining value of his or her interest to the charitable remainderman. The charity's income and remainder interests would merge, the trust would terminate, and the trust assets would pass to charity. In private letter rulings, the IRS has approved several such terminations [see Ltr. Ruls. 9721014, 9529039, 9409017].

Or, another possible solution is for the charity to agree to allow the income beneficiary to contribute his or her interest in exchange for a gift annuity in order to retain an income stream.

Testamentary Charitable Remainder Annuity Trusts

As noted above, the IRS takes the position that a CRAT does not allow the donor to take a charitable deduction if there is a greater than 5% probability that the income beneficiary will exhaust the trust corpus. For instance, if a CRAT is required to pay out 8% and the AFR is 5%, the risk increases that principal will have to be invaded to make the payouts. The CRAT may fail the 5% probability test.

If you have clients who included CRATs in their wills, consider the possibility that the CRAT could come into existence at a time of low AFRs. Such CRATs could fail to qualify for a charitable deduction if the payout percentage is high compared to the prevailing AFR. One solution: lower the payout percentage in the testamentary CRAT by codicil, though not below the 5% minimum payout [IRC Sec. 664(d)(1)(A)]. Another option is to use a testamentary charitable remainder unitrust (CRUT) which is not subject to the 5% probability test [see Ltr. Ruls. 7915038, 8419005].

IN CLOSING

Communicating the importance of AFRs is an instrumental part of discussing planned giving with your clients. If you regularly speak to your clients about their philanthropic goals, your clients will be ready to take advantage of a low interest rate environment to create a gift that will be more satisfying on a personal level.

New Tax Developments

IRS Identifies a Transaction of Interest Involving a Charitable Remainder Trust

The IRS issued Notice 2008-99 which describes a transaction of interest involving a charitable remainder trust (CRT). First, the grantor contributes appreciated property to a CRT. Next, the trustee sells the appreciated property and reinvests the proceeds in new assets. And the grantor and charity coordinate the sale of their interests in the CRT to a third party for approximately the fair market value of the assets within the CRT.

In the transaction of interest scenario, the grantor claims that IRC Sec. 1001(e)(1) – the requirement to disregard basis in the case of the sale of a term interest – does not apply because the entire interest in the trust has been sold. Rather, under IRC Sec. 1001(a) and related provisions, the gain on the sale of the grantor's term interest is computed by taking into account the portion of the uniform basis allocable to the grantor's term interest under Reg. Sec. 1.1014-5 and 1.1015-1(b) with the uniform basis being the basis of the reinvested assets rather than the basis of the assets originally contributed to the CRT.

The IRS is concerned about the grantor's claim of an increased basis in the term interest coupled with the termination of the CRT in a single coordinated transaction under IRC Sec. 1001(e) to avoid tax on gain from the sale or other disposition of the appreciated property. Notice 2008-99 requires parties to disclose these transactions and suggests further action might be taken consistent with labeling the transaction as a means of tax avoidance.

Charitable Giving Provisions within the Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 (EESA) included several provisions that affect charitable giving. Many provisions revive or extend ways of giving that had temporary status. The foremost example is that of the IRA charitable rollover: a donor age 70 1/2 or older may order a distribution directly from an IRA to a qualified charity and exclude that amount from his or her gross income.

EESA included the following renewed items:

- Qualified Charitable Distributions from an IRA
- Favorable basis adjustment for stockholders of S corporations giving to qualified charities
- Favorable deduction rules for contributions of book inventory to schools by C corporations
- Favorable deduction rules for contributions of wholesome food inventory by businesses
- Favorable deduction rules for contributions of computers by corporations

RECENT APPLICABLE FEDERAL RATES (AFRS) FOR CALCULATING THE CHARITABLE DEDUCTION

Month	Rate
September 2008	4.2%
October 2008	3.8%
November 2008	3.6%
December 2008	3.4%
January 2009	2.4%

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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