THE CATHOLIC FOUNDATION

VOLUME XXVII
ISSUE I

THE Good Advisor

# Living Happily After ATRA
## Planned Giving in a "No Estate Tax" Environment

*"The future ain't what it used to be." - Yogi Berra*[1]

No, Yogi, it's not. When Congress engineered the American Taxpayer Relief Act of 2012 (ATRA) to alleviate the fiscal cliff, they created a new world for estate planning. With a large, permanent estate tax exemption indexed for inflation and the addition of portability, income tax planning will likely become more and more important in estate planning.

This is due in large part to higher income tax and long-term capital gains tax rates for individuals with incomes over $400,000 ($450,000 for joint filers). These higher rates also apply to trusts with incomes that exceed annual maximum limits. In addition, a 3.8% net investment income (NII) tax now applies to investment income of individuals and trusts when income exceeds threshold limits.

## Theory and Practice

ATRA's effect on charitable giving is complicated. In theory, charitable planning should be easier now given the "permanency" of the estate tax law changes.[2] A high estate tax exemption coupled with the new portability provisions have relieved all but the wealthiest taxpayers from the need for intensive planning with marital trusts. In theory, donors should be able to focus on long-term solutions.

In practice, however, affluent individuals are subject to the highest transfer tax and income tax rates. The once-preferred method of reducing the taxable estate by gifting appreciated assets may not always be advisable now. Instead, focusing on income taxation and stepped-up basis rules may be a more productive approach for estate planners.

High-income taxpayers (those at or near the top rate of 39.6%) make gifts to fulfill important philanthropic intentions, but they also itemize in order to enjoy the monetary benefits of larger tax deductions. The Pease limitation moderates these deductions. Given that the Pease limitation lumps the charitable deduction with other itemized deductions, clients might be wondering if charitable gifts still make good tax sense. Since the Pease limitation is based on income and not on the amount of itemized deductions, once the Pease limit is calculated and subtracted from the charitable deduction, giving more doesn't increase the Pease tax. Indeed, from a purely tax standpoint, high-income donors may find charitable contributions make more sense now than ever.

In this issue of ***The Good Advisor,*** we review the tax issues donors face and examine strategies for making gifts that are advantageous in today's tax environment.

- Legislative Background
- Pease Limitation on Itemized Deductions
- Managing Tax on Net Investment Income
- Charitable Trust Strategies

## Legislative Background

Prior to the enactment of the American Taxpayer Relief Act, estate planners faced tax provisions that were expressly temporary in nature. More than two years ago, Congress passed ATRA, which permanently[3] increased the estate tax exemption to $5 million[4] and made portability a permanent part of the estate tax landscape. While these changes are widely regarded as favorable and have led to what many describe as a "no estate tax" environment, planners are left to wonder what impact the new tax law environment will have on charitable giving.

While it may be too early to draw a conclusion, it is certainly safe to stress the importance of reviewing individual estate plans and revising them as necessary to adjust to the times. Planners may need to shift their focus from traditional A/B “marital” trust arrangements to income tax considerations. For example, individuals will need to look closely at how charitable giving is affected by limitations on charitable deductions, increased tax rates, the low interest rate environment, and the new tax on net investment income.

## The Pease Limitation on Itemized Deductions

ATRA reinstated what is known as the Pease limitation.[5] The limit begins to apply at specific thresholds of adjusted gross income (AGI)—originally set at $250,000 (single) and $300,000 (married filing jointly), but indexed annually for inflation.[6] For 2015, the thresholds are $258,250 (single) and $309,900 (married filing jointly). Pease limitations reduce itemized deductions by 3% of the amount by which AGI exceeds these income thresholds, but cannot reduce itemized deductions by more than 80%.

Let’s look at an example using the original thresholds for ease of computation. A couple with $400,000 of AGI earns $100,000 over the $300,000 threshold. Therefore, they must reduce their itemized deductions by 3% of that excess $100,000, or $3,000. If they claim $20,000 in itemized deductions on their tax return, the couple would be allowed to deduct only $17,000 after applying the Pease limitation.

But what if a couple’s charitable contributions are included with their other itemized deductions? In this case, the Pease limitation is applied in a pro-rated fashion. Let’s say that a married couple filing jointly has AGI of $500,000 and claims $150,000 in itemized deductions, of which $75,000 (50%) are charitable contributions. Here is how they apply the Pease limitation:

1. **Determine Excess Income:** AGI is $200,000 above the $300,000 threshold
2. **Calculate Deduction Limitation:** Multiply the $200,000 excess by 3% to determine the total itemized deduction limitation of $6,000
3. **Subtract Limitation From Itemized Deductions:** Subtract this $6,000 limitation from total itemized deductions of $150,000 to arrive at $144,000 in allowable deductions
4. **Calculate Limitation’s Effect on Charitable Contribution:** To determine the limit’s effect on the charitable deduction specifically, multiply the $6,000 limitation by the percent of total deductions that were charitable (50%). In this case, the Pease limitation has reduced the couple’s charitable deduction by $3,000—from $75,000 to $72,000.

While this reduction is real, it is important to recognize that once the Pease limit applies, further itemized deductions are not diminished. Consider the same couple, but their itemized deductions are solely comprised of those for state and local taxes. Applying the Pease limitation reduces the couple’s state and local itemized deductions by $6,000 to $144,000. But now, if the same couple decides to make a charitable contribution of $50,000, the Pease limitation will not reduce the value of their charitable deduction since the Pease limitation is driven by the couple’s AGI, not the amount of their itemized deductions.

How is the Pease limitation likely to affect charitable giving? In theory, reducing the amount that donors can take as a charitable deduction reduces the incentive to give. In practice, however, since the Pease limitation is based on income, it is actually more an income tax than a penalty on, or disincentive for, itemized deductions.

Consider that for each $100 of income over the income threshold, $3 is lost in itemized deductions, so taxable income goes up by $103. So for those in the 35% bracket, the Pease limit adds 1.05% to the effective tax rate. This is hardly a reason for donors to forgo charitable contributions, which are typically motivated by factors other than tax reduction. This view is supported by many who follow the effect of tax laws on taxpayer behavior who feel that the Pease limitation will have a negligible effect on charitable giving.[7]

## Managing Tax on Net Investment Income

While ATRA increased the top marginal tax rate to 39.6% and the top capital gains tax rate to 20%, these rates could go as high as 43.4% and 23.8% for individual taxpayers, trusts and estates with significant net investment income (NII).[8] Net investment income generally includes interest, capital gains, dividends, rental and royalty income, and non-qualified annuities, but not Social Security benefits, alimony, most self-employment income or distributions from qualified retirement plans and IRAs.

Under IRC §1411, taxpayers are liable for an additional 3.8% tax on net investment income, (or the amount by which modified adjusted gross income exceeds

certain statutory threshold amounts, if less).[9] The statutory threshold amounts are:

- Married filing jointly — $250,000
- Married filing separately — $125,000
- Single or head of household — $200,000

In the case of an estate or trust, the tax is imposed for each tax year on an amount equal to the undistributed NII, or (if less) the excess of the estate or trust's AGI over the inflation-adjusted dollar threshold (only $12,301 for 2015). Since this threshold is so low, if the net investment income tax applies to a trust or estate, it is important to minimize that tax where possible. Strategies include:

- Shifting income to an individual beneficiary with a higher income threshold
- Investing trust assets in municipal bonds for tax-free income
- Deferring income through the purchase of a tax-deferred annuity
- Making use of charitable trusts

## Charitable Trust Strategies

Trusts which donate income that would otherwise constitute NII effectively reduce amounts subject to the additional tax. Unlike individuals, whose charitable income tax deductions are limited to a certain percentage of their AGI under IRC §170(b), trusts are allowed an unlimited charitable income tax deduction under IRC §642(c).

However, trusts must take care not to violate any of the statutory requirements of IRC §642(c) or the deduction may be disallowed.[10] Charitable contributions must be paid:

- During the tax year
- From gross income (not corpus or principal), including accumulated gross income[11]
- Pursuant to the terms of the trust document
- For a purpose specified in IRC §170(c)

### Charitable Remainder Trusts

The rules of IRC §1411 do not apply to trusts that are specifically exempted under the regulations, including:

- Trusts dedicated to purposes described in IRC §170(c)(2)(B)[12]
- Trusts exempt from tax under IRC §501(c)
- Charitable remainder trusts described in IRC §664

A charitable remainder trust (CRT) provides an annual income to a non-charitable beneficiary during the trust term, then pays the remainder interest to a qualified charity. Since IRC §1411 does not apply to a CRT, the CRT does not pay net investment income tax on items with net investment income (such as capital gains associated with appreciated stock) when they are transferred to, and subsequently sold by, the trust. Any capital gains treatment passed through to the non-charitable beneficiary will be taxed as net investment income according to the higher AGI thresholds applicable to individuals. So, depending on the situation of the individual beneficiary, the net investment income tax may ultimately be avoided, or at least reduced.

### Charitable Lead Trusts

Since today's interest rates are low and the Federal Reserve has indicated that this climate is likely to continue for some time, donors may want to take advantage of these attractive rates by using a Charitable Lead Trust (CLT). A CLT lets donors make a gift to a qualified charity by paying out an annual income to the charity for a specified period of years. At the end of the trust term, the principal passes to the non-charitable beneficiaries (often the children or grandchildren of the donor).

CLTs are especially advantageous when the aplicable Charitable Midterm Federal Rate (CMFR) is low because a low rate increases the present value of the charity's income interest.[13] Conversely, this reduces the valuation of trust assets expected to go to non-charitable beneficiaries. So, if the trust corpus appreciates during the trust term, a greater amount of the appreciation escapes transfer taxation as it ultimately passes to family members.

Of course, individuals should approach giving holistically, with attention to assets, earnings history, wealth management, and charitable goals. Although lead trusts function more favorably in a low interest rate environment, they may not align with the donor's overall goals. Donors who want to leave assets to heirs will prefer a CLT, while donors looking for an income stream will prefer a CRT.

## Not Perfect, But Not Bad…

*"If the world were perfect, it wouldn't be." - Yogi Berra*[14]

ATRA didn't create a perfect estate planning arena, but it certainly removed significant obstacles for most taxpayers. Since only taxpayers with income in excess of $5.43 million ($10.86 million for married couples, taking portability into account) need to concern themselves with the estate tax, most planning will focus on ways to moderate other taxes. Although donors may feel that the financial incentive for giving is less than perfect from a purely tax standpoint, many planners agree that after ATRA, charitable gifts just may be more important than ever for high income taxpayers.

# Endnotes

1 http://www.brainyquote.com. Yogi Berra is well known for his quotes. In a fitting description of his legacy on that front he once told reporters, "I really didn't say everything I said." See, http://en.wikipedia.org/wiki/Yogi_Berra

2 "Permanency" of tax law is something of a misnomer as Congress can, and often does, revise law to achieve policy goals.

3 This is "permanent" in that it is not designed to expire or "sunset" at some fixed date in the future.

4 The exemption is indexed annually for inflation and is $5.43 million in 2015.

5 Named after Congressman Donald Pease (D-Ohio), who introduced the legislation in 1990, the original limitation applied to those with AGI of $100,000. The inflation-adjusted threshold would have been close to $170,000 if it had been reinstated as originally scheduled.

6 Income thresholds also apply to heads of household ($275,000) and marrieds filing separately ($150,000). For 2015, these amounts are $284,050 and $154,950.

7 The Urban Institute Tax Policy Center and the Center on Budget and Policy Priorities have stated that the Pease impact on charitable giving would be negligible, saying: "Because the dollar reduction in itemized deductions under Pease depends on a taxpayer's income rather than on the amount he or she donates, Pease doesn't affect decisions on whether to give more to charity." http://www.urban.org/UploadedPDF/412732-What-Does-the-Fiscal-Cliff-Deal-Mean-for-Nonprofits.pdf

8 The net investment income tax was created to generate revenue needed for the Patient Protection and Affordable Care Act (Pub. L. 111-148).

9 IRC §1411

10 See, e.g., *Crestar Bank v. Internal Revenue Service*, 47 F. Supp. 2d 670 (E.D. Va. 1999)

11 Reg. §1.642(c)-1(a)(1)

12 This includes charities organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

13 With respect to charitable gift planning, the CMFR affects the computation of income, gift, and estate tax charitable deductions for transfers to charitable remainder trusts, pooled income funds, charitable gift annuities, charitable lead trusts, and life estate agreements.

14 http://www.brainyquote.com

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.

Although The Catholic Foundation has been diligent in attempting to provide accurate information, the accuracy of the information in this newsletter cannot be guaranteed. Laws and regulations change frequently and are subject to differing legal interpretations. Accordingly, The Catholic Foundation shall not be liable for any loss or damage caused or alleged to have been caused by the use or reliance upon the information in this newsletter.

THE CATHOLIC FOUNDATION

5310 Harvest Hill Road, Suite 248 • Dallas, TX 75230 • Phone 972-661-9792 • Fax 972-661-0140

www.catholicfoundation.com

THE CATHOLIC FOUNDATION

# Living Happily After ATRA: Planned Giving in a "No Estate Tax" Environment

## In This Issue:

- Legislative Background
- Pease Limitation on Itemized Deductions
- Managing Tax on Net Investment Income
- Charitable Strategies - Trusts and Annuities

# Living Happily After ATRA: Planned Giving in a "No Estate Tax" Environment

*"The future ain't what it used to be."*

- Yogi Berra[1]

No, Yogi, it's not. When Congress engineered the American Taxpayer Relief Act of 2012 (ATRA) to alleviate the fiscal cliff, they created a new world for estate planning. With a large, permanent estate tax exemption indexed for inflation and the addition of portability, income tax planning will likely become more and more important in estate planning.

This is due in large part to higher income tax and long-term capital gains tax rates for individuals with incomes over $400,000 ($450,000 for joint filers). These higher rates also apply to trusts with incomes that exceed annual maximum limits. In addition, a 3.8% net investment income (NII) tax now applies to investment income of individuals and trusts when income exceeds threshold limits.

ATRA's effect on charitable giving is complicated. In theory, charitable planning should be easier now given the "permanency" of the estate tax law changes.[2] A high estate tax exemption coupled with the new portability provisions have relieved all but the wealthiest taxpayers from the need for intensive planning with marital trusts. In theory, donors should be able to focus on long-term solutions.

In practice, however, affluent individuals are subject to the highest transfer tax and income tax rates. The once-preferred method of reducing the taxable estate by gifting appreciated assets may not always be advisable now. Instead, focusing on income taxation and stepped-up basis rules may be a more productive approach for estate planners.

High-income taxpayers (those at or near the top rate of 39.6%) make gifts to fulfill important philanthropic intentions, but they also itemize in order to enjoy the monetary benefits of larger tax deductions. The Pease limitation moderates these deductions. Given that the Pease limitation lumps the charitable deduction with other itemized deductions, clients might be wondering if charitable gifts still make good tax sense. Since the Pease limitation is based on income and not on the amount of itemized deductions, once the Pease limit is calculated and subtracted from the charitable deduction, giving more doesn't increase the Pease tax. Indeed, from a purely tax standpoint, high-income donors may find charitable contributions make more sense now than ever.

In this issue we will review the tax issues donors face and examine strategies for making gifts that are advantageous in today's tax environment.

- Legislative Background
- The Pease Limitation on Itemized Deductions
- Managing Tax on Net Investment Income
- Charitable Strategies - Trust and Annuities

## Legislative Background

Prior to the enactment of the American Taxpayer Relief Act, estate planners faced tax provisions that were expressly temporary in nature. More than two years ago, Congress passed ATRA, which permanently[3] increased the estate tax exemption to $5 million[4] and made portability a permanent part of the estate tax landscape. While these changes are widely regarded as favorable and have led

to what many describe as a "no estate tax" environment, planners are left to wonder what impact the new tax law environment will have on charitable giving.

While it may be too early to draw a conclusion, it is certainly safe to stress the importance of reviewing individual estate plans and revising them as necessary to adjust to the times. Planners may need to shift their focus from traditional A/B "marital trust" arrangements to income tax considerations. For example, individuals will need to look closely at how charitable giving is affected by limitations on charitable deductions, increased tax rates, the low interest rate environment, and the new tax on net investment income.

## The Pease Limitation on Itemized Deductions

ATRA reinstated what is known as the Pease limitation.[5] The limit begins to apply at specific thresholds of adjusted gross income (AGI)—originally set at $250,000 (single) and $300,000 (married filing jointly), but indexed annually for inflation.[6] For 2015, the thresholds are $258,250 (single) and $309,900 (married filing jointly). Pease limitations reduce itemized deductions by 3% of the amount by which AGI exceeds these income thresholds, but cannot reduce itemized deductions by more than 80%.

Let's look at an example using the original thresholds for ease of computation. A couple with $400,000 of AGI earns $100,000 over the $300,000 threshold. Therefore, they must reduce their itemized deductions by 3% of that excess $100,000, or $3,000. If they claim $20,000 in itemized deductions on their tax return, the couple would be allowed to deduct only $17,000 after applying the Pease limitation.

But what if a couple's charitable contributions are included with their other itemized deductions? In this case, the Pease limitation is applied in a pro-rated fashion. Let's say that a married couple filing jointly has AGI of $500,000 and claims $150,000 in itemized deductions, of which $75,000 (50%) are charitable contributions. Here is how they apply the Pease limitation:

1. **Determine Excess Income:** AGI is $200,000 above the $300,000 threshold
2. **Calculate Deduction Limitation:** Multiply the $200,000 excess by 3% to determine the total itemized deduction limitation of $6,000
3. **Subtract Limitation From Itemized Deductions:** Subtract this $6,000 limitation from total itemized deductions of $150,000 to arrive at $144,000 in allowable deductions
4. **Calculate Limitation's Effect on Charitable Contribution:** To determine the limit's effect on the charitable deduction specifically, multiply the $6,000 limitation by the percent of total deductions that were charitable (50%). In this case, the Pease limitation has reduced the couple's charitable deduction by $3,000—from $75,000 to $72,000.

While this reduction is real, it is important to recognize that once the Pease limit applies, further itemized deductions are not diminished. Consider the same couple, but their itemized deductions are solely comprised of those for state and local taxes. Applying the Pease limitation reduces the couple's state and local itemized deductions by $6,000 to $144,000. But now, if the same couple decides to make a charitable contribution of $50,000, the Pease limitation will not reduce the value of their charitable deduction since the Pease limitation is driven by the couple's AGI, not the amount of their itemized deductions.

How is the Pease limitation likely to affect charitable giving? In theory, reducing the amount that donors can take as a charitable deduction reduces the incentive to give. In practice, however, since the Pease limitation is based on income, it is actually more an income tax than a penalty on, or disincentive for, itemized deductions.

Consider that for each $100 of income over the income threshold, $3 is lost in itemized deductions,

so taxable income goes up by $103. So for those in the 35% bracket, the Pease limit adds 1.05% to the effective tax rate. This is hardly a reason for donors to forgo charitable contributions, which are typically motivated by factors other than tax reduction. This view is supported by many who follow the effect of tax laws on taxpayer behavior who feel that the Pease limitation will have a negligible effect on charitable giving.[7]

According to the 2013 Blackbaud Charitable Giving Report,[8] in 2013, online giving grew by 13.5% and overall charitable giving in the United States was up 4.9%. In fact, the report noted that this constituted the largest year-over-year increase in overall charitable giving since the "great recession" of 2007-08. According to their survey, compared to 2012, not a single sector experienced negative growth in 2013—certainly an indication that tax considerations are taking a back seat to other motivations for those deciding to make a gift.[9]

## Managing Tax on Net Investment Income

While ATRA increased the top marginal tax rate to 39.6% and the top capital gains tax rate to 20%, these rates could go as high as 43.4% and 23.8% for individual taxpayers, trusts, and estates with significant net investment income (NII).[10] Net investment income generally includes interest, capital gains, dividends, rental and royalty income, and non-qualified annuities, but not Social Security benefits, alimony, most self-employment income, or distributions from qualified retirement plans and IRAs.[11]

Under IRC §1411, taxpayers are potentially liable for an additional 3.8% tax on net investment income (or the amount by which adjusted gross income exceeds certain statutory threshold amounts, if less). The statutory threshold amounts are:

- Married filing jointly — $250,000,
- Married filing separately — $125,000,
- Single or head of household — $200,000

Obviously, there is no tax liability if a taxpayer has no NII. Likewise, there is no potential tax liability if the taxpayer's AGI does not exceed the applicable income threshold.

**Example 1:** A married couple filing jointly has NII of $130,000 and AGI of $250,000. Their NII is not taxed since their AGI does not exceed the $250,000 income threshold.

**Example 2:** An individual taxpayer has AGI of $220,000 and no NII. Even though AGI exceeds the applicable income threshold of $200,000, without NII, there is no additional 3.8% tax.

**Example 3:** An individual taxpayer has NII of $125,000 and AGI of $330,000. The tax applies to the entire $125,000 of NII since that is less than the excess of the $330,000 AGI over the $200,000 income threshold ($130,000).

**Example 4:** A married couple filing jointly has NII of $200,000 and AGI of $375,000. The tax applies only to $125,000 (the excess of the $375,000 AGI over the $250,000 income threshold) since that is less than the amount of NII.

In the case of an estate or trust, the tax is imposed for each tax year on an amount equal to the undistributed NII, or (if less) the excess of the estate or trust's AGI over the inflation-adjusted dollar threshold (only $12,301 for 2015). Since this threshold is so low, if the net investment income tax applies to a trust or estate, it is important to minimize that tax where possible. Strategies include:

- Shifting income to an individual beneficiary with a higher income threshold
- Investing trust assets in municipal bonds for tax-free income
- Deferring income through the purchase of a tax-deferred annuity
- Making use of charitable trusts

## Charitable Strategies—Trusts and Annuities

Trusts which donate income that would otherwise constitute NII can effectively reduce amounts subject to the additional tax. Unlike individuals, whose charitable income tax deductions are limited to a certain percentage of their AGI under IRC §170(b), trusts are allowed an unlimited charitable income tax deduction under IRC §642(c).

However, trusts must take care not to violate any of the statutory requirements of IRC §642(c) or the deduction may be disallowed.[12] Charitable contributions must be paid:

- During the tax year
- From gross income (not corpus or principal), including accumulated gross income[13]
- Pursuant to the terms of the trust document
- For a purpose specified in IRC §170(c)

### Charitable Remainder Trusts

The rules of IRC §1411 do not apply to trusts that are specifically exempted under the regulations, including:

- Trusts dedicated to purposes described in IRC §170(c)(2)(B)[14]
- Trusts exempt from tax under IRC §501(c)
- Charitable remainder trusts (CRTs) described in IRC §664

A charitable remainder trust (CRT) is a unique kind of irrevocable trust in which the donor or another beneficiary receives income from the trust for life or for a period of up to 20 years, after which the trust terminates and assets are distributed to a qualified charity.[15]

Because a CRT can be arranged to pay a lifetime income to the donor, it often permits the donor to make a major gift to a charitable institution, gaining immediate tax benefits while benefiting from regular income.

Charitable remainder trusts come in two main forms—charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs).

### Charitable Remainder Annuity Trusts

To establish a CRAT, a donor irrevocably transfers cash or appreciated property to the trust. The trust instrument must specify an annual annuity to the donor or other beneficiaries for a certain period of time, often for the lives of the beneficiaries, with the trust property passing to a designated charitable institution at the end of this time period. The value of the charitable remainder must be at least 10% of the net fair market value of all property transferred to the trust, as determined at the time of the transfer. The income beneficiary of a CRAT must receive the required annuity payout each year, even if the trust does not produce any income. If necessary, the trustee will invade the principal to make the required payout.

### Charitable Remainder Unitrusts

A CRUT is similar, but with some key differences. A CRUT pays one or more income beneficiaries a specified percentage of the value of the trust assets as revalued each year (not just based on the initial value). If the trust principal rises in value, the income payout also rises. Once the donor selects the payout rate, it cannot be changed. By careful selection of the trust's payout percentage, a donor can elect to optimize either the charitable deduction or the payout amount.

Another key difference is that a CRUT allows the donor to make additional contributions.

## CRAT and CRUT Comparison

All CRTs share certain key characteristics:

- They are irrevocable
- The annual payout percentage cannot be less than 5% (of the initial value of the trust in the case of a CRAT, or of the annually revalued trust corpus in the case of a CRUT)
- Income beneficiaries cannot receive any payment other than the annuity amount or the unitrust amount—the charitable remainder amount cannot revert to the income beneficiary
- Income payments are taxed in accordance with a four-tier system, in the following order of priority: (1) current and accumulated ordinary income; (2) short-term capital gain, followed by long-term capital gain; (3) "other income" (usually meaning tax-exempt interest); and (4) tax-free return of corpus[16]
- The trust itself is exempt from federal income tax
- The trust term must be measured by the life or lives of one or more individuals living at the time the trust is created, or by a fixed term of not more than 20 years
- The payout rate cannot exceed 50% (of the initial value of CRAT assets, or of the annually revalued CRUT assets)
- The present value of the charitable remainder must be at least 10% of the fair market value of the assets transferred to the trust
- The donor may select one or more charities to receive the remainder interest, and may retain the right to change the charitable beneficiary; however, all CRTs must specify a contingent charitable remainderman in case the primary remainderman ceases to exist or ceases to be a qualified charitable organization

But there are also key differences:

- A CRAT must distribute a fixed percentage of the initial value of the property transferred, whereas a CRUT must distribute a fixed percentage of the annually revalued trust property
- A CRAT prohibits additional contributions but a CRUT may allow them if specified in the terms of the trust
- A CRAT pays out the same amount each year, but the terms of a CRUT may provide for the payout of all trust income in any year in which total trust income is less than the amount required by the fixed percentage (a "net income unitrust"), and may even allow any income shortfalls to be made up at a later time (a "net income with make-up unitrust")

## CRTs and the Net Investment Income Tax

Since IRC §1411 does not apply to a CRT, the CRT does not pay net investment income tax on items with net investment income (such as capital gains associated with appreciated stock) when they are transferred to, and subsequently sold by, the trust. Any capital gains treatment passed through to the non-charitable beneficiary will be taxed as net investment income according to the higher AGI thresholds applicable to individuals. So, depending on the situation of the individual beneficiary, the net investment income tax may ultimately be avoided, or at least reduced.

**Example:** Cleo has an annual salary of $175,000 and owns appreciated stock worth $400,000 for which she paid $100,000. If she were to sell the stock, her capital gain (and NII) would equal $300,000. $275,000 of Cleo's $300,000 in NII would be subject to the additional tax upon the outright sale of the stock, since that is the amount by which her AGI (salary plus NII) exceeds the $200,000 threshold.

If Cleo contributes the stock to a CRT, on the other hand, she can avoid the additional tax on the NII.

Cleo decides to establish a CRUT and names herself as the income beneficiary. As a charitable entity, the CRT does not pay tax on amounts contributed to it.[17] Assume in a given year that payments from the trust consist only of capital gains in the amount of $25,000. These payments constitute NII—however, given Cleo's income (even with the distribution), she does not exceed the income threshold and is therefore not subject to the additional tax.

## Charitable Lead Trust

Since today's interest rates are low and the Federal Reserve has indicated that this climate is likely to continue for some time, donors may want to take advantage of these attractive rates by using a Charitable Lead Trust (CLT). A CLT lets donors make a gift to a qualified charity by paying out an annual income to the charity for a specified period of years. At the end of the trust term, the principal passes to the non-charitable beneficiaries (often the children or grandchildren of the donor).

CLTs are especially advantageous when the applicable Charitable Midterm Federal Rate (CMFR) is low because a low rate increases the present value of the charity's income interest.[18] Conversely, this reduces the valuation of trust assets expected to go to non-charitable beneficiaries. So, if the trust corpus appreciates during the trust term, a greater amount of the appreciation escapes transfer taxation as it ultimately passes to family members.

Of course, individuals should approach giving holistically, with attention to assets, earnings history, wealth management, and charitable goals. Although lead trusts function more favorably in a low interest rate environment, they may not align with the donor's overall goals. Donors who want to leave assets to heirs will prefer a CLT, while donors looking for an income stream will prefer a CRT.

## Charitable Gift Annuity

A non-trust planning option for moderating the NII tax is a charitable gift annuity. A charitable gift annuity is a contract between a donor and a qualified charity. The donor makes an irrevocable gift of appreciated property (in this situation, property that would otherwise generate NII if sold outright), and in exchange, the charity agrees to pay a fixed amount annually for the lifetime of one or two annuitants. The transfer is in part a deductible gift to charity and in part the purchase of an annuity—and that is exactly how federal income tax law views the gift annuity. While it is true that part of the ongoing payments may consist of capital gain, the tax effect is mitigated since these payments are spread over a number of years.

Gift annuities are an exception to the general IRS rules that charitable organizations cannot issue commercial insurance contracts if they want to keep their income tax-exempt status.[19] To qualify for the exception, charities that issue gift annuities must comply with the following rules:

- The present value of the annuity must be less than 90% of the total value of the property transferred in exchange for the annuity.
- The annuity cannot be payable over more than two lives, and the life or lives must be in being at the time the gift annuity is set up.
- The gift annuity agreement between the donor and charity must not specify either a guaranteed minimum or maximum number of annuity payments.
- The amount of the periodic annuity payments cannot be subject to adjustment by reference to the actual income produced by the transferred property or any other property.[20]
- When appreciated property is transferred in exchange for a gift annuity, the resulting capital gains tax liability (recognized because the transfer is in part a taxable exchange of property) can be spread over life expectancy if the donor is the annuitant. This is where the additional tax on NII can be ameliorated or even eliminated.

## Not Perfect, But Not Bad…

*"If the world were perfect, it wouldn't be."*
- Yogi Berra[21]

ATRA didn't create a perfect estate planning arena, but it certainly removed significant obstacles for most taxpayers. Since only taxpayers with income in excess of $5.43 million ($10.86 million for married couples—taking portability into account) need to concern themselves with the estate tax, most planning will focus on ways to moderate other taxes. Although donors may feel that the financial incentive for giving is less than perfect from a purely tax standpoint, many planners agree that after ATRA, charitable gifts just may be more important than ever for high- income taxpayers.

## Endnotes

1 http://www.brainyquote.com. Yogi Berra is well known for his idiosyncratic quotes. He once told reporters, "I really didn't say everything I said."

2 "Permanency" of tax law is something of a misnomer as Congress can, and often does, revise law to achieve policy goals.

3 This is "permanent" in that it is not designed to expire or "sunset" at some fixed date in the future.

4 The exemption is indexed annually for inflation and is $5.43 million in 2015.

5 Named after Congressman Donald Pease (D-Ohio), who introduced the legislation in 1990, the original limitation applied to those with AGI of $100,000. The inflation-adjusted threshold would have been close to $170,000 if it had been reinstated as originally scheduled.

6 Income thresholds also apply to heads of household ($275,000) and married couples filing separately ($150,000). For 2015, these amounts are $284,050 and $154,950.

7 The Urban Institute Tax Policy Center and the Center on Budget and Policy Priorities have stated that the Pease impact on charitable giving would be negligible, saying: "Because the dollar reduction in itemized deductions under Pease depends on a taxpayer's income rather than on the amount he or she donates, Pease doesn't affect decisions on whether to give more to charity." http://www.urban.org/UploadedPDF/412732-What-Does-the-Fiscal-Cliff-Deal-Mean-for-Nonprofits.pdf

8 Blackbaud Inc. supplies fundraising, website management, education administration and other services designed for nonprofit organizations.

9 While the report does not specifically address how the Pease limitation may or may not have affected the rise in giving, it notes the factors that contributed to the robust increase—investments made in people, process, and technology during the recession, improving economic conditions and a robust stock market. See https://www.blackbaud.com/files/resources/downloads/2014/2013.CharitableGivingReport.pdf

10 The net investment income tax was created to generate revenue needed for the Patient Protection and Affordable Care Act (Pub. L. 111-148).

11 The final IRC §1411 regulations define net investment income as gross income from interest, dividends, annuities, royalties, and rents, except to the extent excluded by the ordinary course of a trade or business exception. See, Reg. §1.1411-4(a). Extensive exclusions are found under Reg. §1411-4(b), et. seq. and a full explanation is beyond the scope of this summary.

12 See, e.g., Crestar Bank v. Internal Revenue Service, 47 F. Supp. 2d 670 (E.D. Va. 1999)

13 Reg. §1.642(c)-1(a)(1)

14 This includes charities organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

15 See, IRC §664(d)

16 See, IRC §664(b)

17 Distributions made to income beneficiaries would, however, be subject to tax in accordance with the four-tier system set forth under IRC §664(b).

18 With respect to charitable gift planning, the CMFR affects the computation of income, gift, and estate tax charitable deductions for transfers to charitable remainder trusts, pooled income funds, charitable gift annuities, charitable lead trusts, and life estate agreements.

19 See, IRC §501(m)

20 These are the so-called "Clay-Brown" rules under IRC §514(c)(5) under which the qualified charity avoids being taxed on revenues received from gift annuities.

21 http://www.brainyquote.com

THE
CATHOLIC
FOUNDATION

5310 Harvest Hill Road, Suite 248 • Dallas, TX 75230 • Phone 972-661-9792 • Fax 972-661-0140

www.catholicfoundation.com

This booklet 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 booklet 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.

Although The Catholic Foundation has been diligent in attempting to provide accurate information, the accuracy of the information in this booklet cannot be guaranteed. Laws and regulations change frequently and are subject to differing legal interpretations. Accordingly, The Catholic Foundation shall not be liable for any loss or damage caused or alleged to have been caused by the use or reliance upon the information in this booklet.