# Philanthropic Estate Planning

**By Janet Nava Bandera**

## What Is Hot and What Is Not in the Charitable Giving World

On the same day early this month, I received e-mail alerts telling me that the American Council on Gift Annuities (ACGA) reduced its recommended charitable gift annuity rates and that the June Charitable Federal Mid-Term Rate (CFMR) was set at 3.6 percent. The only time the CFMR has been lower than this was from 1954 to 1970 when it was fixed at 3.5 percent.

As a member of the Heritage League, which is the planned giving board for the American Cancer Society's Heartland Division, much of my time is dedicated to encouraging planned gifts. This is a challenge given market conditions, the lack of appreciated stock and low annuity rates. But even in this environment, there are bright spots. We must simply look for giving plans that are positively affected by low rates. With that in mind, I set out to determine what's hot and what's not in giving today.

### Charitable Lead Trusts

A charitable lead trust (CLT) is a trust that holds income producing property. The trust is set up to pay income to charity for a period of time (five, 10 or 20 years, or the donor's lifetime), with individuals (noncharities) receiving the remaining trust principal at termination. There are two types of lead trusts and within those, two alternatives for income tax treatment.

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.

A nongrantor lead trust is a nonreversionary trust. It does not provide an up-front tax deduction, but, during the term of the trust, the donor's adjusted gross income is reduced because the income generated by the investments is no longer taxable to the donor.

A grantor lead trust allows some portion of the trust to revert to the donor. Such a trust may allow the donor to take a charitable deduction in the year of the transfer. The donor reports trust income on his personal tax return even though the charity is receiving the income.

Are lead trusts affected by the CFMR? For donors wanting to establish a nongrantor CLAT, the low interest rates are an advantage. With the CLAT, the CFMR is used as the discount rate to determine the present value of the annuity interest (the amount that will be paid to the charity). Thus, the lower the CFMR, the higher the gift and estate tax charitable deductions (and the income tax deduction for grantor CLATs) and the lower the present value of the remainder interest to the noncharitable beneficiaries.

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.

The CFMR does affect the choice between grantor and nongrantor lead trusts. This is because, in order for a tax deduction to be allowed for a grantor trust, at termination the trust must return more than five percent 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.

*Janet Nava Bandera, J.D., is the Principal of The Bandera Law Firm, P.C. Ms. Bandera specializes in estate and charitable planning and serves on the Boards of two private foundations as well as the Heritage League of the American Cancer Society in St. Louis. She may be reached at The Bandera Law Firm, 700 Corporate Park Drive, Suite 340, Clayton, MO, 63105, (314) 691-4386.*

### *Charitable Remainder Trusts*

Like charitable lead trusts, charitable remainder annuity trusts (CRATs) are highly affected by the CFMR and charitable remainder unitrusts (CRUTs) are barely affected. There are two tests applicable to charitable remainder trusts. The first, applicable to lifetime annuity trusts, is whether there is a five-percent probability that the trust assets will be exhausted prior to the charity's receipt of the remainder interest (the five-percent test does not apply to unitrusts or annuity trusts measured by a fixed term of years).

The five-percent test is highly sensitive to the CFMR because 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). So, to pass the test and qualify as a charitable trust, the discount rate must approach less than a one-percent difference from the payout rate.

The second test is that the present value of the remainder interest must be at least 10 percent. For the same reason as above, at the present CFMR of 3.6 percent, many annuity trusts will fail this test (the longer the term, the greater the chance it will fail).

With a CRUT, the CFMR affects only the payment frequency adjustment factor. Thus, a CRUT is hardly affected. 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 Gift Annuity*

Why and how does the CFMR affect the gift annuity rates?

The general rule in Code Sec. 501(m) is that charitable organizations cannot issue commercial insurance contracts if they want to keep their income tax-exempt status. This means that organizations that issue gift annuities are required to comply with the so-called "Clay-Brown" rules.[1]

These rules are:

- The present value of the annuity must be less than 90 percent 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 a 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.

Because IRS rules require that the charity get at least 10 percent of the present value, the effect of the CFMR on gift annuities is identical to its effect on charitable remainder annuity trusts. A declining CFMR increases the minimum age for individuals to qualify for a charitable gift annuity.

Thus, when the CFMR is more than one percent less than the annuity rate, the donor must have a shorter life expectancy to pass the present value test. Based upon CFMR of 3.6 percent and the recommended charitable gift annuity rates, a single life annuitant must be at least 60 years old.

### *Life Estate Agreement*

The CFMR is used as the discount rate when gifting a remainder interest in a personal residence or farm. The lower the rate, the less the discount and the higher the present value of the remainder interest (the charitable deduction). This example taken from an IRS publication illustrates the difference.

> **Example.** A person aged 60 donates to State University a remainder interest in her personal residence consisting of a house and land, reserving a life estate interest for herself. At the time of the gift, the land has a value of $50,000 and the house has a value of $200,000 with an estimated useful life of 45 years, at the end of which the residual value of the house is expected to be $10,000. The donor elects to use the interest rate for the month in which the gift takes place.
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> At 8.6 percent, the present value of the remainder interest of $1.00 payable at the death of the donor is $0.24892. The value of the remainder interest or the charitable deduction is $48,479.70.
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> At 3.6 percent, the present value of the remainder interest of $1.00 payable at the death of the donor is $0.508420. The value of the remainder interest, the charitable deduction is $89,808.00.

## Conclusion

There are opportunities even in today's market; you just have to know what is hot and what is not.

| HOT | NOT |
|---|---|
| CLATs | Grantor CLUTs |
| CRUTs | CRATs |
| LEAs | CGAs |

ENDNOTES

1 Code Sec. 514(c)(5).