FINANCIAL STRATEGIES
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Fall 2016

Planning Implications of Low Discount Rates

In August the applicable federal rate determined under **Internal Revenue Code 7520** and used to value the respective charitable and noncharitable interests of split-interest gifts fell to 1.4%, its lowest level since July 2013 and within 0.4% of the all-time low of 1.0%. It remained at 1.4% for September. The exact level of the discount rate is extremely important to charitably minded taxpayers who are contemplating a significant contribution because it has a direct effect on the relative tax implications of different kinds of split-interest gifts.

The impact of the rate can cut both ways, depending on the kind of gift a prospective donor is considering.

Low-Rate Challenges

A low discount rate has the effect of driving down the resulting income-tax charitable deduction for life-income gifts.

- **Charitable Gift Annuities (CGAs).** Tax law allows a donor to make a contribution to a qualified charity in exchange for a fixed annuity payment for the life of one or two annuitants and generate an income-tax charitable deduction for the value of the charity's interest.

These charitable gift annuities are contracts between the issuing charity and the donor. Charitable gift annuities are general obligations of the charity and are not secured by the proceeds of the gift annuity. The charity has a continuing obligation to make the contracted payment even if all of the funds contributed for the annuity have been depleted.

The amount of the deduction is determined primarily by the amount of the gift annuity contribution, the amount of the annuity paid annually, and the age(s) of the beneficiary(ies). Many charities follow the maximum suggested rates of the American Council on Gift Annuities, although they are not required to use those rates unless mandated by state law. The suggested maximum rates increase as the age of the beneficiary(ies) increases, and rates are lower for two people than for one person of the same age.

The applicable discount rate also has a meaningful impact on the amount of the available deduction. For example, the charitable deduction for a $100,000, 5.1% charitable gift annuity payable to a 70-year-old annuitant is $35,821 with the discount rate at 1.4%. At 3.0% the deduction rises to $43,771—and at 5% it goes all the way up to $51,594.

By way of historical perspective, the discount rate has not been as high as 3% since 2011 and has not been as high as 5% since 2007. The high point for the discount rate was 11.6% in 1989, shortly after the switch from a fixed rate to a rate that changes monthly. The rate has been below 2% since February of this year.

- **Charitable Remainder Trusts (CRTs).** **CRT**s generally make payments to noncharitable beneficiaries either for the life or lives of the named beneficiary or beneficiaries or for a specified period of time not to exceed 20 years, after which remaining trust assets pass to one or more qualified charities. The value of the charitable remainder interest qualifies for an income-tax deduction if the gift is made during life or an estate-tax charitable deduction if the gift is testamentary.

CRTs can be in the form of either a charitable remainder annuity trust (**CRAT**), which makes fixed payments

Rev. Proc. 2016-42 Provides Alternative to Avoid 5% Probability Test Challenge

The Internal Revenue Service has issued **Rev. Proc. 2016-42**, which provides a sample provision to allow charitable remainder annuity trusts (**CRAT**s) to qualify that otherwise may fail the "probability of exhaustion" test set forth in **Rev. Rul. 70-452** and applied in **Rev. Rul. 77-374**. That test provides that no deduction is available for any **CRAT** for which there is more than a 5% probability that payments to the income beneficiary or beneficiaries will exhaust the trust corpus prior to the end of the trust term.

Rev. Proc. 2016-42 contains a sample provision, which may be included in the governing instrument of a **CRAT**, that the **IRS** indicates will be treated as a qualified contingency within the meaning of Internal Revenue Code **§664(f)**. Specifically, this provision provides for early termination of the trust (and thus the end of the ability to make any more annuity payments) on the date immediately before the date on which any annuity payment would be made if the payment of that annuity amount would result in the value of the trust corpus—when multiplied by a specified discount factor —being less than 10% of the value of the initial trust corpus.

This creates significant new possibilities for planning with **CRAT**s. It is much more difficult for a proposed **CRAT** to pass the 5% probability test when the applicable federal discount rate determined under **IRC §7520** is near historic lows, as it has been in recent years.

SECTION 5 of Rev. Proc. 2016-42 contains the sample provision:

> The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus, when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to $[1 / (1 + i)]^t$, where *t* is the time from inception of the trust to the date of the annuity payment, expressed in years and fractions of a year, and *i* is the interest rate determined by the Internal Revenue Service for purposes of section 7520 of the Internal Revenue Code of 1986, as amended (section 7250 [*sic*] rate), that was used to determine the value of the charitable remainder at the inception of the trust. The section 7520 rate used to determine the value of the charitable remainder at the inception of the trust is the section 7520 rate in effect for [insert the month and year], which is [insert the applicable section 7520 rate].

The language is for a one-life inter vivos **CRAT**, but annotations give guidance for adapting the statement for other situations.

for the duration of the trust term, or a charitable remainder unitrust (**CRUT**), which makes payments that are a stated percentage of the value of the trust principal as it changes from year to year.

Low discount rates present special challenges for **CRAT**s. A low discount rate certainly drives down the deduction. A $100,000 **CRAT** for a 70-year-old beneficiary with a 5% payout rate produces a $52,543 deduction with the discount rate at 5% and $44,946 at 3%.

The actuarial value of the charitable remainder interest when the discount rate is 1.4% is even lower at $38,686—but there is another big problem. No deduction is available for a **CRAT** if there is more than a 5% probability that the entire corpus of the trust will be exhausted by making periodic payments before the time the trust is actuarially predicted to end. A 5% **CRAT** for a 70-year-old beneficiary fails the 5% probability test with the discount rate at 1.4%. This is particularly challenging since 5% is the minimum payout allowed.

Conversely, a **CRUT** is far less affected by changes in the discount rate. In the case of a $100,000 **CRUT** with a 5% payout to a 70-year-old beneficiary, the charitable deduction would be $52,174 with the discount rate at 1.4%. With the discount rate at 3%, the deduction would increase to only $52,476 and at 5% to $52,845.

Some donors may find a **CRUT** to be a viable alternative to a **CRAT** when the discount rate is lower or if they have issues satisfying the 5% probability test. For an additional option for dealing with the 5% probability test, see **"Rev. Proc. 2016-42 Provides Alternative to Avoid 5% Probability Test Challenge"** in the box to the left.

Low Rates Beneficial to Some Gifts

Low discount rates do not always mean less attractive tax benefits for all gifts. The swing in tax implications of low discount rates can be just as significant in a positive direction for some kinds of gifts as it is negative in the case of others:

- **Gift of a remainder interest in a farm or personal residence.** A donor can transfer a farm or a personal residence to charity subject to the donor's right to reside in the house or farm for the rest of his or her life and qualify for a charitable deduction equal to the present value of the charity's remainder interest.

  The amount of the deduction is a function of several factors, the most significant of which are the value of the property and the age(s) of the donor(s). It can also be significantly affected by the discount rate:

  Example: Don and Paula, both aged 75, have long intended to leave their home, currently worth $500,000, to us at the death of the survivor of them. This kind of testamentary gift would qualify for an estate-tax charitable deduction but may not generate any actual savings unless Don and Paula's taxable estates exceed the estate-tax equivalent exemption at the time of their deaths.

  That is currently $5,450,000 per individual, which means that between them they could currently pass up to $10,900,000 free of tax to noncharitable beneficiaries. Moreover, any part of the equivalent exemption not used by the first spouse to die can be used by the surviving spouse at his or her death.

  Because they do not expect to be subject to federal estate tax, Don and Paula are intrigued that there is a way they can fulfill their charitable objective of directing the house to us and generate current income-tax savings while they are still alive. Accordingly, they make a gift of the remainder interest in their home to us and retain a life estate for as long as either of them lives.

  If the discount rate is 1.4% at the time of their gift, they will be entitled to an income-tax charitable deduction of $342,535. They will continue to live in, enjoy, and maintain their home just as before, but it will automatically pass to us at the death of the survivor of them.

  By comparison, if the discount rate was at 3.0%, the deduction would drop to $276,477.50. At 5% it would go all the way down to $214,915.

It may be helpful to think of the discount rate as a way of putting a value on the right to use or possess an asset. In the case of a retained life estate, the discount rate essentially reflects the value of the right to live in and enjoy the property. As such, if the discount rate goes up, the value of those rights goes up—and when it goes down, the value of those rights goes down.

Conversely, because the value of the retained life estate and the remainder interest must add up to the current fair-market value of the property, it follows that if the value of the retained life estate goes down when the discount rate goes down, the value of the remainder interest goes up. This results in a higher deduction.

- **Charitable Lead Trusts (CLTs).** A **CLT** essentially functions as a mirror image of a charitable remainder trust. A grantor funds the trusts, which then makes payments to a charitable income beneficiary for the trust term—which may be expressed in years or may be for the life or lives of qualifying designated individuals—before ultimately distributing the remaining trust assets to designated individuals or entities.

A nongrantor **CLT**, in which the remainder does not revert to the grantor, has powerful potential to reduce or eliminate the gift-tax and/or estate-tax cost of passing assets to noncharitable beneficiaries. The value of the charitable income interest in the trust is subtracted from the principal contributed to the trust, and only the excess—if any—is treated as a taxable gift. As such, a **CLT** is particularly attractive to persons who anticipate being subject to estate and/or gift tax.

The level of the discount rate is a major consideration in planning a **CLT.** Assume, for instance, that a mother contributes $5,000,000 to a charitable lead annuity trust that will pay us $250,000 each year for the next 20 years. At the end of the 20 years, all remaining trust assets will be divided equally between her two children.

When the discount rate is at 1.4%, the present value of those 20 payments of $250,000 is $4,334,750. This means that only $665,250 is treated as a taxable transfer. No matter how large the trust corpus grows by the time it is distributed to the children, there will be no additional gift or estate tax.

However, the value of the charitable interest drops to $3,719,350 when the discount rate is at 3% and $3,115,550 when it is at 5%. Many high-net-worth individuals are finding charitable lead trusts to be very appealing with the discount rate at historic low levels.

Briefly…

Tax Court Denies Deduction for Gift of Artwork. The Tax Court has denied a claimed deduction for a contribution of an artist's work to charity (Kaplan v. Commissioner, T.C. Memo. 2016-149) in addition to other adverse rulings for the taxpayer. The taxpayer had claimed a "thrift shop value" of one dollar each for postcards she had created that she donated to charity. The Tax Court pointed out that, as the creator of the item, she was entitled to deduct only her actual cost in creating the items rather than their fair-market value. Because the taxpayer did not produce evidence relating to the cost of producing the items, the Tax Court did not allow her to claim any deduction at all.

Set-Aside for New Facility Counts for Minimum Required Payout. A private foundation has received approval from the **IRS** to treat funds set aside for a new facility as qualifying for the annual required payout (**PLR 201628022**). The foundation operates a program for hands-on education experiences for children and provides water quality analysis for adults in a facility that is very restrictive and inadequate for its needs. The **IRS** determined that the project was consistent with purposes under **IRC §170(c)(2)(B)** and met the requirements of **IRC §4942(g)(2)(B)**, in that the funds for the project would be paid out within 60 months and the foundation had demonstrated that the project could better be accomplished with payments over time rather than currently. Accordingly, amounts set aside for the project could be treated by the foundation as qualifying toward its minimum required payout obligation.

Chief Counsel Memorandum Speaks on Appraisal Requirement for Gift of Coins. The IRS has responded to a question from a taxpayer as to whether a qualified appraisal is needed to substantiate the value of a coin or a coin collection with a claimed value in excess of $5,000 with a definite "usually" **(CCA 201608012)**. The memorandum noted that there is a "readily valued property" cash exception to the appraisal requirements in **IRC §170(f)(11)(A)(iii)(I)**. However, it went on to say that section was not applicable to a contribution of coins unless (1) the value claimed by the donor for the coins does not exceed the face amount, and (2) the coins are acceptable as legal tender.

Many taxpayers hold precious metals as part of an overall investment strategy. Sometimes this can be in actual ingots or, perhaps more commonly, in coins made from precious metals like gold and silver. In the case of coins made from silver or gold, it would be highly unlikely that the true fair-market value of the coin would not be more than the face value of the coin as currency. Even if it could be used as legal tender—the advisability of which may be unlikely, given the presumed higher value of the metal than the face value of the coin—an appraisal would still be necessary according to the memorandum if the claimed deduction exceeds the face value of the coins.

IRS Newswire Warns of Scams in Wake of Tragedies. The IRS has warned taxpayers to be wary of fraudulent solicitations of charitable contributions tied to significant tragic events **(IR-2016-19)**. The warning was issued specifically in response to concerns about such activity following the loss of many lives in the shooting in Orlando earlier this year.

With the unfortunate rise of such events, the IRS encourages potential donors to check out the legitimacy of organizations soliciting donations. It points donors to the irs.gov Web site and its search feature, "Exempt Organizations Select Check," through which people may find qualified charities. In addition, the IRS recommends not giving or sending cash. For security and tax-record purposes, the IRS suggests contributing by check or credit card or another way that provides documentation of the gift.

Financial Strategies *is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep these planners up to date on developments in estate planning as they relate to testamentary and lifetime plans in support of qualified charities.*

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