FUNDAMENTALS OF PLANNED GIVING

PART FOUR: ADVANCED PLANNED GIVING METHODS

PG CALC WEBINAR

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INTRODUCTION

Even though the vast majority of planned gifts are simple charitable bequests, successful development officers still find it well worth their while to maintain at least a conversational knowledge of the more advanced planning giving methods. First of all, these advanced planned gifts are, for the most part, irrevocable, and therefore arguably better for the charitable organization because they cannot be changed or revoked like a simple bequest. In addition, the development officer who has a working knowledge of advanced planned giving methods is in a better position to be of service to his or her donors and can be helpful to them in creating charitable gift plans that benefit the donor and the organization.

LIFE INCOME GIFTS

In the simplest terms, a "life income gift" is a plan that allows a donor to make a contribution to charity and receive an income in return. Depending upon the plan, the income may be fixed or variable and it can go on for one or more lifetimes, a term of years, or a combination of the two. Later we will explore a number of specific plans. However, they have the following features in common:

- are irrevocable once the contribution has been made
- provide a current income tax deduction for the calculated value of the charitable gift
- can be made during lifetime or included in a Will or other testamentary instrument
- subject to both Federal and state laws

Life income gifts offer distinct advantages—and disadvantages—for both the donor and the charity:

- **For the donor** – the ability to receive income, avoid capital gains tax, and shift investment strategies are advantages. However, donors must also consider that these gifts are irrevocable and there is very little flexibility should the donor wish to make changes after the gift is made
- **For the charity** – the irrevocability of these gifts is an advantage compared to other planned gifts which can be changed or even revoked without the charity being aware. However, the charity must consider that it will need to establish relationships—sometimes lifelong—with the donor and beneficiary and take responsibility for fiscal and fiduciary matters

Types of Life Income Gifts

Charitable Gift Annuity

- Money, property, or other assets are irrevocably given to a charity now in exchange for a contractual promise to pay a fixed amount each year to one or two beneficiaries
- The amount of payment is set at the time the gift is made and cannot be changed

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- One or two annuitants are named at the time the gift is made and cannot be changed
- The date of the first annuity payment may be delayed (deferred payment gift annuity)
- Payments are backed by the charitable organization that issues the gift annuity

Charitable Remainder Trust

- Money, property, or other assets are irrevocably transferred to a trustee with instructions to pay income to one or more income beneficiaries for a period of time and then to transfer the funds remaining in the trust to charity
- Two types:
    - **Annuity trust** – pays a fixed dollar amount to the income beneficiaries
    - **Unitrust** – pays a fixed percentage of the value of the trust, as re-determined annually, to the income beneficiaries
- Trustee may be the charity, a trust company, an individual, or others
- Payout method (annuity or percent of trust value), rate or amount of payout, income beneficiary(ies), and other terms of trust are set at the time the gift is made and cannot be changed

Pooled Income Fund

- Many donors irrevocably contribute money, property, or other assets to a pooled investment fund operated by a charity
- Income beneficiaries are paid a share of the fund's net income proportionate to the value of their contribution
- As income beneficiaries die, their share of the fund is withdrawn for use by the charity

By the Numbers

Conceptually, a life income gift is "split interest" gift because the donor splits her or his ownership of the money or property into two separate interests: the right to own and the right to receive income. The donor contributes only the right to own but retains the right to income. The full fair market value of the money or property is the combined value of both interests, but since the donor has contributed only one of the interests, the income tax charitable deduction is less than the full fair market value of the property or money contributed.

Following is a brief overview of how the amount of the deduction is calculated:

- In general, the charitable deduction is the estimated economic value of the contribution to the charity—the value of the money or property contributed, minus the value of the right of the income beneficiary to receive income

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- Formulae, factors, and other variables, including a discount rate[1] are specified by U.S. Treasury Regulations
- Charitable Gift Annuity
  - Begin with the amount of cash or the fair market value of property or other assets contributed
  - Then subtract the present value of the lifetime annuity (which represents the value retained by the donor)
  - The result is the amount of the charitable deduction
- Charitable Remainder Trust or Pooled Income Fund
  - Begin with the amount of cash or the fair market value of property or other assets contributed
  - Then subtract the present value of the income expected to be paid to the beneficiaries (which is the value retained by the donor)
  - The result is the amount of the charitable deduction
- General rules of thumb:
  - **Older beneficiaries, lower payouts = larger deduction** – the older the beneficiary and/or the lower the payout, the larger the deduction because the charity can be expected to pay less to the income beneficiary thus leaving more for charity
  - **Younger beneficiaries, higher payouts = smaller deduction** – the younger the beneficiary and/or the higher the payout, the smaller the deduction because the charity can be expected to pay more to the income beneficiary. It is also true that more beneficiaries results in a smaller deduction.
- Technology to the rescue!

  Fortunately for development officers, readily available software can provide quick and accurate calculations. The *PGM Anywhere* service and *Planned Giving Manager* software by PG Calc® can calculate deductions and compare different gift plans and options (e.g., sell and reinvest versus making a contribution). In addition, the user can model financial results over time and prepare appealing presentations and formal documentation.
- Note that annuity interests (those paying a fixed dollar amount) are more affected by CMFR fluctuations than unitrust interests. The CMFR fell to historically low rates during the 2008-09 financial crisis and, in June 2020, reached the lowest rate ever recorded. The low CMFR makes the deduction for charitable gift annuities and charitable remainder

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[1] The "Applicable Federal Rate" (AFR), sometimes called the "Charitable Midterm Federal Rate" (CMFR) or the "7520 Rate," is the IRS discount rate used to determine the charitable deduction for most planned gifts. It is the assumed rate of return that the gift assets will earn during the gift term. The IRS discount rate changes monthly. It equals 120% of the annualized average yield of U.S. Treasury instruments over the past 30 days that have remaining maturities of 3-9 years. The higher the IRS discount rate, the higher the deduction for charitable remainder trusts and gift annuities, and the lower the deduction for charitable lead trusts and retained life estates. Fluctuations in the IRS discount rate affect unitrust deductions far less than annuity trust and gift annuity deductions.

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annuity trusts relatively low and the deduction for charitable lead annuity trusts and retained life estates relatively high.

CHARITABLE GIFT ANNUITY

A charitable gift annuity is a contractual promise issued by the charity to pay a fixed dollar amount annually for the lifetime of one or two individuals. The contract is issued in exchange for an irrevocable contribution. Gift annuity contracts are fully backed by the financial assets of the charity that issues the annuity.

Annuity Payments and Amount

Payments to the income beneficiary (annuitant) must be at least annual but can be more often. Quarterly is a common payment schedule. Payments can start now or at some fixed date in the future (a "deferred payment gift annuity").

The amount of the annuity is fixed at the time the gift is made and cannot be changed. Although the amount can be negotiated between the charity and the donor, in most cases the amount is set by referring to the rates suggested by the American Council on Gift Annuities (ACGA). For example, following are the ACGA suggested (as of July 2020) maximum rates for a single-life gift annuity for various ages:

Age	Rate
5-8	1.5%
9-13	1.6%
14-17	1.7%
18-21	1.8%
22-24	1.9%
25-28	2.0%
29-30	2.1%
31-33	2.2%
34-35	2.3%
36-37	2.4%
38-39	2.5%
40-41	2.6%
42	2.7%
43-44	2.8%
45	2.9%
46-47	3.0%
48	3.1%
49	3.2%

Age	Rate
50	3.3%
51	3.4%
52	3.5%
53-54	3.6%
55-56	3.7%
57-58	3.8%
59-60	3.9%
61-62	4.0%
63	4.1%
64-65	4.2%
66	4.3%
67	4.4%
68	4.5%
69	4.6%
70	4.7%
71	4.8%
72	4.9%
73	5.1%

Age	Rate
74	5.2%
75	5.4%
76	5.6%
77	5.8%
78	6.0%
79	6.2%
80	6.5%
81	6.7%
82	7.0%
83	7.2%
84	7.4%
85	7.6%
86	7.8%
87	8.0%
88	8.2%
89	8.4%
90+	8.6%

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PG Calc's *PGM Anywhere* service and *Planned Giving Manager* software are regularly updated with the ACGA's most current suggested rates. Current suggested gift annuity rates for both single and two-life gift annuities are available at the American Council on Gift Annuities Web site: https://acga-web.org

Annuitants (Beneficiaries)

There can be no more than two beneficiaries of a charitable gift annuity contract, and they both must be named at the time the gift annuity is issued.

Taxation of Annuity Payments

The payment to the beneficiary of a gift annuity is taxed as follows:

- **Part tax-free** – a portion of each payment is deemed to be due to the donor's "investment in the contract," and a return of that which already belongs to the donor which is therefore tax-free
- **Part taxed as capital gain income** – if long term capital gain property was contributed and the donor is the annuitant (which is usually the case), then the portion of the payment deemed to be "investment in the contract" that is attributable to the capital gain will be taxed as capital gain income. (If the donor is not the annuitant, then the donor must report all of this capital gain in the year of the gift and the tax-free portion of the annuity payments becomes greater.)
- **Ordinary income** – the remainder of the payment is taxed as ordinary income

Payments after the end of the donor's actuarial life expectancy are taxed entirely as ordinary income because the donor is assumed to have recovered his or her entire "investment in the contract."

State Regulation

Charitable gift annuities are subject to regulation under state law. Many states exempt charitable gift annuities from regulation, while others require registration of the gift annuity and some require annual reporting. Some states regulate only the charities in the state, other states take the position that out-of-state charities must comply with state regulations if a state resident makes a gift in exchange for a gift annuity. The American Council on Gift Annuities is a good resource for current state regulations. Charitable organizations should consult their own advisors before issuing gift annuities, especially if donors reside out of state.

Required Disclosure

The Philanthropy Protection Act (1995) exempts most life income gifts from securities registration requirements provided that (among other things) full and complete disclosure is made to prospective donors prior to the making of a gift. PG Calc's *PGM Anywhere* service and *Planned Giving Manager* software include a disclosure statement designed to meet these requirements.

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Charitable Gift Annuity Examples

Assume a donor, age 72, wishes to contribute $25,000 in exchange for a charitable gift annuity, naming herself as the annuitant. Following are the results for a contribution of cash:

***Example:* Charitable Gift Annuity Funded with Cash**

Assumptions:	
Annuitant Age	72
Cash Donated	$25,000
Annuity Rate	4.9%
Payment Schedule	quarterly
Charitable Deduction (CMFR = 0.8%)	**$10,161**
Annuity	**$1,225**
Tax-free Portion	$1,023
Ordinary Income	$202

After 14.5 years, the entire annuity becomes ordinary income.

Now assume the donor funds the gift annuity with appreciated securities now worth $25,000 for which she paid $5,000 a number of years ago. Note that the only difference is in the taxation of the annuity payments.

***Example:* Charitable Gift Annuity Funded with Appreciated Property**

Assumptions:	
Annuitant Age	72
Principal Donated	$25,000
Cost Basis	$5,000
Annuity Rate	4.9%
Payment Schedule	quarterly
Charitable Deduction (CMFR = 0.8%)	**$10,161**
Annuity	**$1,225**
Tax-free Portion	$205
Capital Gain Income	$818
Ordinary Income	$202

After 14.5 years, the entire annuity becomes ordinary income

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Deferred Payment Charitable Gift Annuity

The deferred payment gift annuity is a variation on the charitable gift annuity in which the date of the first annuity payment is delayed until one or more years after the date of the gift. The date of the first payment must be fixed at the time the annuity contract is issued and cannot be changed. Other than the deferred first payment date, the deferred payment gift annuity agreement is similar to the regular charitable gift annuity. Since the first annuity payment is deferred, usually for several years, the charity can agree to a higher annuity amount than a regular immediate payment annuity.

Example: **Deferred Payment Charitable Gift Annuity Funded with Cash**

Assumptions:

Annuitant Age at Date of Gift	55
Age at Date of First Payment	65
Principal Donated	$25,000
Cost Basis	$25,000
Annuity Rate	5.6%
Payment Schedule	quarterly
Charitable Deduction (CMFR = 0.8%)	**$7,173**
Annuity	**$1,400**
Tax-free Portion	$934
Ordinary Income	$466

After 19.9 years, the entire annuity becomes ordinary income.

Charitable Remainder Trusts

There are many different types of trusts, some with highly specialized uses. In general, trusts function as follows:

- The grantor (or donor) transfers money or property to a trustee along with a legal instrument providing instructions for operation of the trust (the trust agreement)
- The trustee:
  - Holds, sells, invests, and reinvests the trust's assets
  - Makes payments to the income beneficiaries as directed in the trust agreement
  - Then, when the trust ends, distributes the remainder as directed in the trust agreement

A trust can be *inter vivos* (set up during grantor's lifetime) or testamentary (created after death through the Will of the grantor).

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Trusts are generally subject to state law.

A charitable remainder trust (CRT) is a special type of trust which is tax-exempt under Federal law. A charitable remainder trust separates the right to receive the income (the income interest) from the right to eventually own the trust assets themselves (the remainder interest). In order to qualify as a CRT, a trust must meet several specific requirements. Among them are:

- Donor must contribute to charity an irrevocable right to the remainder interest
- Trust may not be perpetual, but can last for one or more lifetimes, a term of years (not to exceed 20), or a combination of lifetimes and years, set at the time the trust is created
- The income payout is set at the time the trust is created and cannot be changed. The payout must be at least 5% and not more than 50%.
- The charitable deduction must be at least 10% of the amount contributed to the trust (which restricts high payouts and limits the allowable number and ages of beneficiaries).
- The trust agreement must include certain specific provisions, including:
  - Acknowledgement that the trust is irrevocable
  - At least one of the income beneficiaries must be an individual
  - Payments to the income beneficiary must be made at least annually
  - Income interest must be an “annuity trust” or “unitrust” interest
  - Remainder beneficiary must be a charitable organization

There is no capital gains tax on the transfer of capital gain property to the trust and, since charitable remainder trusts are tax exempt entities, the trust does not pay capital gains tax if subsequently it sells the appreciated property.

Charitable Remainder Trust Types

There are two types of charitable remainder trust, which differ in how the amount paid to the income beneficiary is determined:

- **Annuity trust** pays a fixed dollar amount to the income beneficiary. The amount may be determined as a percentage of the amount contributed, but once the dollar amount is determined, it never changes. (For this reason, an annuity trust *may not* accept additional contributions.)
- **Unitrust** pays a fixed percentage of the value of the trust fund, as re-valued each year. Once the percentage is set, it does not change. However, since the value of the trust fund changes each year, the actual dollar amount paid to the income beneficiary will vary from year to year. A unitrust *may* accept additional contributions.

  Further, there are four types of charitable remainder unitrust. In each case, the trustee values the trust assets each year and applies the unitrust percentage in order to

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determine the amount than can be paid for the coming. However, the actual amount paid to the income beneficiaries is determined depending upon the type of unitrust.

- **"Basic," "Standard," "Type I," or "SCRUT"** – the trustee pays the unitrust payment amount and can distribute principal if required to make the payment
- **"Net Income," "Type II," or "NICRUT"** – the income beneficiary receives the unitrust payment amount or the trust's net income, whichever is less, but the trustee must not distribute principal—for example, if the unitrust payout rate is 5% but the trust earns only 4%, the beneficiary will receive the smaller amount
- **"Net Income with Make-Up," "Type III," or "NIMCRUT"** – pays the unitrust payment amount or the trust's net income, whichever is less (just like the Net Income Unitrust), but keeps track of shortfalls and pays make-up payments in years when there is excess income
- **"Flip Trust"** – begins as either a "Net Income" or "Net Income with Make-up" type, but then transforms into a "Standard" type upon the occurrence of some event in the future, such as the sale of a piece of real estate or a specific date

Note: With the exception of a "Flip" provision, a unitrust cannot change its type once it is created.

Selecting the Charitable Remainder Trust Payout Percentage

The selection of the charitable remainder payout percentage is a critical element in the creation of a successful charitable remainder trust. Donors are often inclined to select a high payout with the expectation that it will result in larger payments for the income beneficiaries. However, setting the payout too high can cause the trust to erode principal value which not only reduces the amount available for charity but can ultimately reduce the amount paid to the income beneficiaries.

The payout percentage must be set at the time the gift is made and cannot be changed later. By law the percentage cannot be less than 5% and cannot be so high that the resulting charitable deduction is less than 10% of the amount contributed. When discussing the payout with a donor, keep in mind the following points:

- A higher payout percentage reduces the value of the charitable deduction. Depending upon the IRS discount rate in effect at the time of the gift, a 1% increase in a unitrust payout amount can result in a significant loss in the charitable deduction as illustrated in the following table:

Charitable Deduction for $500,000 Contribution to a Unitrust

Payout Rate:	5%	6%	7%	8%	9%	10%
One Life 72	$275,880	$247,900	$223,630	$202,505	$184,055	$167,900
Two Lives 72	$219,785	$187,920	$161,110	$138,515	$119,425	$103,265
IRS Discount Rate is 0.8%						

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- If the unitrust payout percentage is set higher, the trustee may be forced to select riskier investments in order to produce an investment return sufficient to meet the payout percentage. Riskier investments can bring greater variability in the trust—higher highs, hopefully, but also lower lows.
- Finally, if the unitrust payout percentage is set much higher than the excepted investment return (and the unitrust is not a net income type), the trust may be forced to consume principal in order to make the unitrust payments each year.

Income Taxes to Beneficiaries

The income received by the income beneficiary is subject to taxation depending upon the source of the funds the trustee uses to make the payment. Since the charitable remainder trust itself is tax-exempt, it pays no income taxes. Essentially, the trust passes through the income tax obligation when it makes distributions to its income beneficiaries. In other words, the dollars paid to the income beneficiary retain the same tax character they would have had if the trust had been required to pay income tax itself. For example, when the trust collects interest income it pays no income tax; however, if the trust then distributes that interest income to an income beneficiary, the beneficiary will have to pay income tax on the interest.

The trustee must follow a strict set of rules to determine which funds it uses to make payments to the income beneficiaries. The so-called "Four Tier Payout Rule" specifies that the trustee must payout income in the following order:

- First, all "net income" (interest and dividends) and any undistributed net income from previous years—which is taxed as ordinary income to the beneficiary
- Second, all realized capital gains income and any undistributed capital gains income from previous years—which is taxed as capital gain income
- Third, all tax-exempt income and any undistributed tax-exempt income from previous years—which is tax-exempt to the beneficiary
- Finally, principal of the trust—which is tax-free to the income beneficiary

In tiers that include more than one kind of income, the income taxed at the highest rate must be distributed first. For example, bond interest and qualified dividends are both forms of ordinary income, but bond interest is taxed at a higher rate than qualified dividends, so all of the bond interest will be distributed before any of the qualified dividends. Likewise, short term capital gain and long term capital gain are both forms of capital gain, but short term capital gain typically is taxed at a higher rate than long term capital gain, so all short term capital gain typically will be distributed before any short term capital gain.

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***Example*: an $25,000 payment from a unitrust might consist of four types of income**

Interest (ordinary income taxed up to 37%)	$7,500
Long-term capital gains (taxed up to 20%)	12,500
Tax-exempt income	2,500
Return of principal	2,500
TOTAL	$25,000

For a beneficiary in the 24% marginal income tax bracket and 15% capital gain tax bracket, the income tax on this distribution would be $3,675 ($7,500 x 24% + $12,500 x 15%), as compared to $6,000 if the payout had been all ordinary income (24% x $25,000). Note that, if applicable, the Net Investment Income Tax could add 3.8% to the beneficiary's tax rate.

Caveat Regarding Securities Laws

Ambiguity regarding the application of securities laws to life income gifts and the necessity to register certain plans with the Securities Exchange Commission as investment securities was resolved by the Philanthropy Protection Act (1995), which exempts life income gifts from securities registration requirements provided that (among other things) full and complete disclosure is made to prospective donors prior to the making of a gift.

Charitable Remainder Trust Examples

Assume a donor, age 72, decides to create a charitable remainder unitrust that will pay him 5% of the value of the trust fund each year for the rest of his lifetime. Following is a summary of the results:

***Example:* 5% Charitable Unitrust**

Assumptions:

Beneficiary Age	72
Amount Donated	$500,000
Payout Rate	5%
Payment Schedule	quarterly 3 months to 1st payment
Charitable Deduction (CMFR = 0.8%)	$275,880
Estimated Income in First Full Year (future income will vary with trust value)	$25,000.00

Life Income Projections

Sometimes it can be helpful to provide prospective donors with an illustration of the projected value of a charitable remainder trust over their lifetimes. Following is an example of a life income projection for the charitable remainder trust illustrated above, assuming that the contribution is appreciated property:

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Example: **Lifetime Income Projection for 5% Unitrust**

Assumptions:
Projection runs for 18 years, life expectancy of a 72 year old.
Original principal is $500,000. Cost basis is $100,000 (20%).
Donor and Beneficiary income tax brackets are 37%, 20% for capital gains.
Medicare surtax (3.8%) applies, so effective rates are 40.8% and 23.8%.
Net total investment return (2% income + 4% appreciation) is 6% per year.
Contributed assets are sold in first year.

A) Gross Principal Contributed	$500,000
B) Income Tax Charitable Deduction (CMFR = 0.8%)	$275,880
C) Income Tax Savings	$102,076
D) After Tax Cost of Gift (A-C)	$397,924
Total Before-Tax Income to Beneficiary	**$490,369**
Projected Remainder for Charity	**$598,074**

Finally, donors might wish to consider a charitable remainder trust as an alternative to selling an appreciated property, paying the capital gains tax, and reinvesting the proceeds. The following example compares the charitable remainder trust with selling and reinvesting (and making no gift at the present time). This example makes the same investment assumptions for both alternatives. Note that the charitable remainder trust results in greater income and a larger total Benefit when total income and the remainder to charity or heirs are added together. The reason is that the capital gains tax is not paid and therefore the trust begins with a larger amount of capital to invest.

Example: **Unitrust vs. Sell & Reinvest**

Assumptions:
Projection runs for 18 years, life expectancy of a 72 year-old.
Original principal is $500,000. Cost basis is $100,000 (20%).
Donor and Beneficiary income tax brackets are 37%, 20% for capital gains.
Medicare surtax (3.8%) applies, so effective rates are 40.8% and 23.8%.
Net total investment return (2% income + 4% appreciation) is 6% per year.
Contributed assets are sold in first year.
Sold & Reinvested beneficiary withdraws 5% per year, remainder reinvested.

	5% CRUT	**Sold & Reinvested**
Gross Principal	$500,000	$500,000
Capital Gains Tax	$0	$95,200
Net Principal After Sale	$500,000	$404,800
Charitable Deduction (CMFR = 0.8%)	$275,880	$0
Tax Savings	$102,076	$0
Total Before-Tax Income to Beneficiary	**$490,369**	**$397,200**
Remainder to Charity or Heirs	**$598,074**	**$484,200**
Total Benefit	**$938,390**	**$799,177**

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CHARITABLE LEAD TRUSTS

The charitable lead trust is, essentially, the inverse of a charitable remainder trust. A charitable lead trust pays income to one or more charities and then distributes its remainder to one or more individuals, just the opposite of a charitable remainder trust.

Like the charitable remainder trust, there are two types of charitable lead trusts:

- **Annuity Lead Trust** – pays a fixed dollar amount each year
- **Unitrust Lead Trust** – pays a fixed percentage of the trust's value each year

Unlike the charitable remainder trust, there are no "net income" or "flip" options available with a unitrust-type charitable lead trust.

Further, since charitable lead trusts are not tax-exempt, the donor must choose the tax treatment of the trust when it is created. There are two types:

- **Non-grantor lead trust** – The trust's income each year is not taxable to the grantor (donor). The donor receives no income tax deduction for creating the trust, but does receive a gift tax deduction based upon the present value of the charity's right to receive income.
- **Grantor lead trust** – The trust's income each year is taxable to the grantor (donor). The donor receives an income tax deduction based upon the present value of the charity's right to receive income, but receives no gift tax deduction.

Charitable lead trusts are most often used in sophisticated financial and estate planning as a method to reduce gift and estate taxes. The most common use is a non-grantor charitable lead trust used to eventually pass assets to heirs with reduced gift or estate taxes. While the details of this application are very complex, these are the essential points:

- When a donor creates a charitable lead trust, he or she makes an irrevocable contribution to charity extending over a number of years, but he or she also makes an irrevocable gift to the individual who will eventually receive the remainder of the trust.
- Like any other gift to an individual, the gift of the remainder interest is subject to the gift tax. Since the charitable lead trust is irrevocable, the taxable gift is deemed to have been made at the time the trust is funded, even though the individual will not receive the remainder until sometime in the future.
- However, the donor can use the gift tax deduction from the non-grantor charitable lead annuity trust to reduce—or in some cases eliminate—the amount of the taxable gift. The donor can also use his or her lifetime gift tax exemption ($11.58 million in 2020) to reduce or eliminate any gift tax due. The $15,000 annual gift tax exclusion is not available for lead trust gifts. The very low CMFR in recent years has made the gift tax deduction for a charitable lead annuity trust unusually high, which has made it an attractive alternative for donors who are concerned about gift and estate taxes.

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The target audience for charitable lead trusts is highly affluent individuals and families who are most concerned about estate and gift taxes. In order to take maximum advantage of the tax incentives offered by a charitable lead trust, the donor must be able to afford to part with the income from a significant sized asset, as well as the asset itself, in return for estate and gift tax savings.

Charitable Lead Trust Example

Assume a wealthy donor is willing to commit $10 million to a charitable lead trust that will pay an annual amount to charity for 20 years before distributing its principal to his heirs. If the charitable payout is set high enough, the donor will receive a Federal gift tax deduction equal to the funding amount of $10 million, eliminating any taxable gift on his transfer of the remainder to his heirs, as illustrated below:

Example: **Charitable Lead Trust eliminates gift taxes**

Assumptions:
Non-grantor charitable annuity lead trust runs for 20 years.
Trust is funded with $10 million dollars.
Trust makes annual payments of $545,000 to charity.
Remainder is distributed to the donor's heirs.
Donor's estate will eventually be taxed at the then current Federal Estate Tax rates.

Results:

- Over the 20-year term of the trust, the charity will receive a total of $10,900,000 million in equal annual payments of $545,000.
- The donor will have made an irrevocable gift to his or her heirs of the remainder interest in the trust. Although this potentially will be a taxable gift, the gift and estate tax deduction resulting from the contribution to the lead trust will "zero out" the taxable gift, eliminating the possibility of gift or estate tax on the transfer to heirs.
- At the end of the trust, 20 years from now, the heirs will receive whatever is remaining in the trust without any gift taxes.
- Assuming that this gift would otherwise have been taxed at the current highest estate and gift tax rates, this is a potential tax savings of $4 million.

Note : This example assumes that the gift and estate tax system and its rates remain in place for the next 20 years. If the estate tax is reduced (or eliminated), then a bequest to the heirs might produce a more favorable tax result.

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RETAINED LIFE ESTATE

A donor can irrevocably contribute his or her personal residence or farm to charity but retain the right to continue to live in it for his or her lifetime. This gift arrangement is called a "retained life estate."

The donor receives a current income tax deduction for the calculated value of the remainder interest that has been contributed to charity.

The donor continues to be responsible for routine expenses—maintenance fees, insurance, property taxes, repairs, etc.—while retaining the right to live in the property.

If, later on, the donor decides to vacate the property, he or she can simply accelerate the charity's right to fully own the property and receive an additional income tax deduction at that time. Less commonly, the donor may work with the charity to rent all or part of the property to someone else or sell the property in cooperation with the charity.

Once the retained life estate ends, the charity can then sell or use the property for its charitable purposes.

Example: **Retained Life Estate in a Personal Residence**

Assumptions:

Life Tennant Age	72
Value of Property	$500,000
Cost Basis of Property	$100,000
Value of Buildings	$350,000
Useful Life of Buildings	45 years
Salvage Value of Buildings	$75,000
Charitable Deduction (CMFR = 0.8%)	**$382,440**

Notes: Retained life estate agreements are not limited to a private residence or home. Any property used by the donor as a "personal residence" can be used, not only a principal residence. Vacation homes and recreational property, for example, make excellent gifts of this type.

A retained life estate in a farm need not be the entire farm property.

(Text adapted from the book *Planned Giving in a Nutshell* and used with permission of the author.)

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