



# PLANNED GIFT CALCULATIONS YOU SHOULD UNDERSTAND

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## **I. Introduction**

Gift planning is replete with calculations of many kinds. Gift planning software makes it mercifully easy for gift planners to generate many of these calculations, but the ease with which gift planners can produce these numbers also can obscure their meaning. There is logic underlying the calculation of the charitable deduction available for funding a gift annuity, for example. But what is that logic? The purpose of this presentation is to answer this and other questions about how calculations of interest to gift planners are done and why.

## **II. Present Value**

The concept of present value is central to understanding many planned gift calculations. Here's one person's definition of present value:

“Value today of a future payment, or stream of payments, discounted at some appropriate compound interest - or discount - rate. The present value method, also called the discounted cash flow method, is widely used in corporate finance to measure the return on a capital investment project. In security investments, the method is used to determine how much money should be invested today to result in a certain sum in a future time.”

- Downes, John, Dictionary of Finance & Investment Terms.

The point is that money received today is worth more than money received in the future because you can invest it and earn a return on your investment. Some refer to this as the “time value of money.”

Present value is a way of determining the value today of receiving money sometime in the future. Three factors affect the present value: the amount that will be received, the length of time until the amount will be received, and the interest rate at which the payment will be discounted.

Expressed mathematically, present value looks like this:

$$PV = 1/(1 + r)^n \times FV$$

where

PV = Present Value

FV = Future Value

R = rate of return (discount rate)

n = number of years in which the future value will be received

**Example:** The present value of \$10,000 received in a lump sum in 10 years, assuming one could invest it at 8% if one had the money today, is \$4,631.93, calculated as follows:

$$PV = 1/(1 + .08)^{10} \times 10,000$$

In Excel the formula would be = POWER (1/(1+.08),10)\*10000

### **Net present value (present value of payments received over a period of years)**

To calculate the present value of a stream of income, you use the present value equation and add the present value of each cash flow together to get a *net* present value (NPV).

$$NPV = PV_1 + PV_2 + PV_3 + \dots$$

**Example:** The present value of receiving \$1,000 each year for the next 3 years, assuming an 8% discount rate is \$2,577.10, calculated as follows:

$$\begin{aligned} NPV &= [1/(1 + .08) \times \$1,000] + [1/(1 + .08)^2 \times \$1,000] + [1/(1 + .08)^3 \times \$1,000] \\ NPV &= \$925.93 + \$857.34 + \$793.83 = \$2,577.10 \end{aligned}$$

In Excel, the formula would be =NPV(.08, 1000, 1000, 1000)

Notice that the present value of the payment made 3 years from now is less (\$793.83) than the payment made 1 year from now (\$925.93). The longer you have to wait, the less valuable the payment is in current dollars.

The interest rate you use has a large effect on the result. If we change 8% to 2%, the NPV increases to \$2,883.88.

$$NPV_{2\%} = \$980.39 + \$961.17 + \$942.32 = \$2,883.88$$

### III. IRS Discount Rate

Known by many names - Charitable Mid-term Federal Rate (CMFR), Applicable Federal Rate (AFR), Section 7520 Rate, Rate of the Month - the IRS discount rate is the interest rate used when computing the charitable deduction for a split-interest gift, such as a gift annuity, charitable remainder trust, or retained life estate. The rate is updated monthly by the IRS. It is published around the 20<sup>th</sup> of the previous month. A donor can elect to use the rate for the month of gift or for either of the prior two months. To use the rate for either of the two months prior to the month of gift, the donor must attach an explicit election to his or her federal income tax return.

So, how is the IRS discount rate determined each month?

The rate equals 120% of the Federal Midterm Rate, rounded to the nearest 0.2%. What this means is that the rate equals the average annual yield percentage on government debt instruments with remaining maturities of three to nine years (medium term bonds). Thus, on a specific day each month, the IRS averages the annual market yield over the past 30 days of medium-term Treasury instruments, multiplies by 1.2, rounds to the nearest 0.2%, then publishes the result as the IRS Discount Rate.

How is the IRS discount rate used in deduction calculations? We'll get to that shortly, but first we need to understand how a mortality table works.

### IV. Mortality Table

A mortality table is a table of expected survivors at each age, given an assumed number of survivors at the starting age for the table. A mortality table is based on the mortality experience of a large sample of people.

For example, the first lines of the Table 2000CM mortality table, which is based on data from the 2000 U.S. Census, look like this:

### Age Survivors

0	100000
1	99305
2	99255

The table is saying that out of a population of 100,000 at age 0, 99305 will be alive at age 1 and 99255 will be alive at age 2. The table continues on this way up to age 110, at which point the number of people alive out of the original 100,000 declines to 0.

A mortality table can be used to compute life expectancies or the probability that a person of a certain age will live to achieve a certain older age. For example, the likelihood that someone age 1 will survive to age 2 according to the 2000CM mortality table is 99305/99255 or 99.9496%.

Per IRS regulations, PG Calc software uses the Table 2000CM mortality table in its charitable deduction computations. We expect the IRS to announce soon a new mortality table, based on the 2010 U.S. Census, for this purpose. Also as required by IRS regulations, PG Calc software uses the 1983 Basic mortality table to compute how long a gift annuity will distribute tax-free and capital gain income.

There are several mortality tables in use in gift planning. In order of "conservativeness," they are:

Table 2012 IAR	Has replaced Annuity 2000 for computing gift annuity reserves for gift annuities created since 1/1/2015 in most regulating states
Table Annuity 2000	Required for computing gift annuity reserves for gift annuities funded in California (since 2005) and Hawaii (since 2001). Also can be used in most regulating states to compute reserves for gift annuities funded from 1998-2000 (depending on the state) to 1/1/2015.
Table 1983 Basic	Used to compute expected return multiple for gift annuities
Table 1983 A	Can be used to compute gift annuity reserves in most regulating states for gift Annuities funded prior to 1998-2000 (depending on the state)
Table 2000CM	Required by IRS for computing deductions as of July 1, 2009
Table 90CM	Required by IRS for computing deductions, July 1, 1999 – April 30, 2009; may be used for FASB liability calculations
Table 80CNSMT	Required by IRS for computing deductions, July 1, 1989 – April 30, 1999

The 2012 IAR, Annuity 2000, and 1983 A tables are gender-biased – males and females have different mortality experiences. The other tables are gender neutral. In addition, the 2012 IAR table is dynamic and is adjusted every year according to a table of anticipated mortality improvement. For example, according to 2012 IAR a male who turns 77 in 2019 will, on average, not live as long as a male who turns 77 in 2020.

## V. Valuing a lifetime annuity

A charitable gift annuity pays a fixed amount each year to an annuitant for life. By adding a mortality factor to the net present value equation discussed earlier and using the IRS discount rate as the net present value interest rate, we can determine the value today of being promised a lifetime annuity.

The formula looks like this:

Value of annuity =  $(PV_1 \times P_{a1}) + (PV_2 \times P_{a2}) + (PV_3 \times P_{a3}) + \dots$

where  $P_{a\#}$  = probability an annuitant will be alive to receive the annuity that year, and  $PV_{\#}$  = the present value of the payment to be received that year.

For example, if  $PV_1 = \$925.93$  and  $P_{a1} = .99$ , then the present value of being promised that payment =  $\$925.93 \times .99$  or  $\$916.67$ . You then go through the same calculation for every future year that the annuitant could be alive – up to age 109 when using Table 2000CM – and add up all the individual products to determine the present value of the lifetime annuity. In the context of planned giving, this is the approach to valuing the lifetime annuity payable by a gift annuity or a charitable remainder annuity trust (CRAT). There can be adjustments for payment frequency and, in the case of a CRAT, for the possibility of the trust will run out of money and therefore terminate early, but the basic approach is as described.

Notice that life expectancy, which we will look at in detail in a moment, is not part of the equation. There is no assumption that for a given beneficiary age that the payments will last a certain length of time. Rather, at each age, we use a mortality table to determine the probability the beneficiary will be alive to receive a payment. This is why a CRAT that will make payments for the lifetime of someone with a 10-year life expectancy will produce a different deduction than a CRAT with a 10-year fixed term.

## **VI. Charitable deduction**

The charitable deduction for a split interest gift, such as a charitable gift annuity or charitable remainder trust, equals the amount transferred to fund the gift minus the value of the non-charitable interest, which makes sense. The value to the charity is the amount being transferred minus the value that doesn't go to charity and the donor earns a charitable deduction equal to the value of the gift to charity.

Gift annuity: In the case of a gift annuity, the deduction equals the amount transferred minus the value of the lifetime annuity, the calculation of which we just looked at in detail. This value of the annuity is sometimes referred to as the donor's "investment in the contract," so the deduction for a gift annuity equals the amount transferred minus the investment in the contract.

When looking at detailed deduction calculations produced by gift planning software, you will notice a line called the "Value of a \$1." This is the present value of each dollar of the lifetime annuity, given the age(s) of the annuitant(s) and the IRS discount rate. The investment in the contract is this value of \$1 multiplied by the amount of the annuity.

The lower the IRS discount rate, the larger the value of each dollar of annuity and, hence, the lower the charitable deduction. The affect can be substantial. For example, the table below shows the deduction for a \$100,000 CGA with a 75-year-old annuitant.

<b>IRS Discount Rate</b>	<b>Deduction</b>
2.0%	\$40,418
3.0%	\$44,318
4.0%	\$47,793

Using the highest of the three available IRS discount rates when computing the deduction for the gift will result in the highest charitable deduction for the donor, but there is a trade-off. It will also result in the lowest tax-free portion of the annuity. In cases where the donor wishes to maximize the tax-free portion of the annuity, the lowest available IRS discount rate will be the best choice.

**Charitable remainder annuity trust:** The approach for computing the deduction earned by a CRAT is similar to that for a gift annuity. The major difference is that the present value of the annuity paid by a CRAT is reduced when, per IRS assumptions, there is the possibility that the CRAT may run out of funds and therefore stop making annuity payments before its last beneficiary dies. This can happen when the payout rate of the CRAT is greater than the IRS discount rate, which is always the case these days because the IRS discount rate is 2% and a CRAT payout rate is required to be at least 5%.

As with the CGA, the lower the IRS discount rate, the lower the charitable deduction and the affect can be substantial. It is unequivocally to the donor's advantage to use the highest of the three available IRS discount rates when computing the deduction for the gift.

**Charitable lead annuity trust:** The approach for computing the deduction earned by a CLAT is exactly the same as the approach for a CRAT, except the donor's charitable deduction is for the present value of the payments, since that is what the charity will receive rather than what's left in the trust when it terminates. Most lead trusts are set up to last for a fixed term of years, in which case valuing the annuity payments becomes a straight net present value calculation with no mortality component.

The lower the IRS discount rate, the *higher* the charitable deduction and the affect can be substantial. It is unequivocally to the donor's advantage to use the lowest of the three available IRS discount rates when computing the deduction for the gift.

**Charitable remainder unitrust:** A standard CRUT pays a percentage of its value as revalued each year. Hence, if it grows in value its payment increases proportionally and if it shrinks in value its payment decreases proportionally. Think of the CRUT as a pie that may get bigger or smaller each year and whose payment is always the same size wedge removed from the pie. Regardless of how big or small the pie gets, the same proportion will go to the income beneficiaries and the same proportion will be left for the charity. As result, what is important in figuring out the deduction for a CRUT is the portion of the pie that will be removed each year (i.e., the payout rate) and the likelihood payments will be made each year. The IRS discount rate doesn't enter into the calculation, except in a small way by affecting a minor adjustment for the payment frequency.

The lower the IRS discount rate, the lower the charitable deduction, but the affect is minimal. That being said, it is unequivocally to the donor's advantage to use the highest of the three available IRS discount rates when computing the deduction for the gift.

For example, the table below shows the deduction for a \$100,000 5% CRUT with a 75-year-old income beneficiary.

<b>IRS Discount Rate</b>	<b>Deduction</b>
2.0%	\$60,108
3.0%	\$60,280
4.0%	\$60,449

**Charitable lead unitrust:** Similar to the relationship between the deduction calculation for a CRAT and a CLAT, the approach for computing the deduction earned by a CLUT is exactly the same as the approach for a CRUT, except the donor's charitable deduction is for the present value of the payments.

Opposite of the CRUT, the lower the IRS discount rate, the *higher* the charitable deduction, but like the CRUT the affect is minimal. It is unequivocally to the donor's advantage to use the lowest of the three available IRS discount rates when computing the deduction for the gift.

**Retained life estate:** The deduction for an RLE is the value of the property transferred minus the value of the retained interest. The value of the retained interest is split between the depreciable portion of the gift – the value of the buildings minus their salvage value - and the non-depreciable portion of the gift – the value of the land plus the salvage value of the buildings. In each case, the value is based on the value of having use of the property each year and the likelihood that a beneficiary will be alive to use it. The value of using the property is based on the IRS discount rate. For example, if the IRS discount rate is 2%, the value of using the property for one year is 2% of the value of the property. As you might expect, then, the deemed value of using the property increases as the IRS discount rate increases.

As with a lead annuity trust, the lower the IRS discount rate, the higher the charitable deduction, and the affect can be significant. It is unequivocally to the donor’s advantage to use the lowest of the three available IRS discount rates when computing the deduction for the gift.

**Pooled income fund:** A pooled income fund distributes all of its income for the lives of one or more beneficiaries. In a way similar to the retained life estate, the beneficiaries have use of the property in the form of the income it generates for as long as they live. However, rather than look to the IRS discount rate to determine the value of that use, we look to the historic income rate earned by the PIF over the prior three tax years. Whichever of those years had the highest income rate, that becomes the valuation rate for new gifts to the PIF. If the PIF is too young to have three years of income history, we assume an income rate based on an adjusted average of the IRS discount rate each of the last three calendar years. For 2019 and 2020, that valuation rate is 2.2%.

Since a PIF uses its own historical income rate in determining the deduction for a gift, the IRS discount rate is irrelevant.

## **VII. Life Expectancy**

Gift planners are often unclear about how a mortality table and a life expectancy differ. Perhaps explaining how a life expectancy can be derived from a mortality table will help clarify how they are related, but not the same.

Life expectancy is a representation of how much longer a person is expected to live, given the person's current age and, in the case of a gender-biased mortality table such as 2012 IAR, gender. A person with a particular life expectancy has an equal chance of dying before or after the number of years in his or her life expectancy.

A person's life expectancy is derived from a mortality table, such as the Table 2000CM discussed earlier. Here are the last few years of the 2000CM mortality table:

<b>104</b>	248
<b>105</b>	144
<b>106</b>	81
<b>107</b>	43
<b>108</b>	22
<b>109</b>	11
<b>110</b>	0

The life expectancy of a 104-year-old based on this table, is the number of survivors at each subsequent age divided by the number of survivors at 104, summed up:

$$144/248 + 81/248 + 43/248 + 22/248 + 11/248 + .5 = 1.714$$

We add the .5 in order to bring the life expectancy into the middle of the year.

The joint-life expectancy calculation is a little more complex. Rather than compute a single probability for each future year, we must compute the probability that at least one of the persons will be alive that year. This probability is one minus the probability both persons will be dead that year.

For example, the joint-life expectancy of two people, 104 and 105, is:

$$(1 - (1 - 144/248) \times (1 - 81/144)) + (1 - (1 - 81/248) \times (1 - 43/144)) + (1 - (1 - 43/248) \times (1 - 22/144)) + (1 - (1 - 22/248) \times (1 - 11/144)) + (1 - (1 - 11/248)) + .5 = 2.347$$

**I think you will agree that we should all be very grateful that software can do these sorts of tedious calculations for us in an instant!**

## **VIII. Taxation of Planned Gift Payments**

### **Taxation of Gift Annuity Payments**

The taxation of gift annuity payments is determined at the time of the gift and is unrelated to the character of the income earned by the gift annuity assets after donation. The taxation of the payments depends on the type of property given.

**Cash gift:** If a gift annuity is funded with cash, part of the annuity will be tax-free for the life expectancy of the annuitant(s) and the rest will be considered ordinary income. Ordinary income is taxed at the annuitant's marginal income tax rate. If the annuitant(s) live beyond life expectancy, the annuity will be considered entirely ordinary income from then on.

For example, the payments from a \$10,000 CGA funded on 11/14/2019 that makes payments at the end of each calendar quarter to a 75-year-old would be taxed as follows over the life of the annuity:

#### **TAX BREAKDOWN OF ANNUITY:**

	Tax-free Portion	Ordinary Income	Total Annuity
2019 to 2019	62.67	18.20	80.87
2020 to 2031	480.50	139.50	620.00
2032 to 2032	129.53	490.47	620.00
2033 onward	0.00	620.00	620.00

You can see that the last bit of tax-free portion runs out in 2032, the year the annuitant will reach the end of his life expectancy. After that, the annuity is all ordinary income.

The portion of the annuity that is tax-free is determined by a fraction called the exclusion ratio. This ratio tells us how much of each annuity payment is excluded from ordinary income. The exclusion ratio is determined as follows:

1. Compute the annuitant's investment in the contract. Recall that this is the present value of the lifetime of annuity payments.



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2. Compute the estimated total value of all the annuity payments the annuitant is expected to receive. Known as the “expected return,” this amount is simply the annuity amount multiplied by a life expectancy value.
3. Divide the investment in the contract by the expected return.

This is all well and good, but why these steps? Conceptually, the investment in the contract is the part of the original donation that will be returned to the annuitant over his or her life expectancy. The difference between this investment in the contract and the expected return is income that will be earned by the gift annuity assets after donation. Earned income is taxed. Returned principal is not. Hence, part of the annuity is deemed returned principal that is tax-free for the life expectancy of the annuitant(s) and the rest is considered earned (ordinary) income. If the annuitant lives beyond life expectancy, the annuity is considered entirely ordinary income from then on because all the investment in the contract will have been returned at that point.

**Long term capital gain property:** If the gift annuity is funded with appreciated property, the ordinary income portion of the annuity is the same as if it were funded with cash, but the excluded portion may be entirely capital gain or may be part capital gain income and part tax-free. The fraction of the excluded portion that is reported as capital gain is the same as the donor’s percentage cost basis in the gift asset. For example, if the donor gives 100 shares of stock worth \$100/share that cost the donor \$30/share, 30% of the excluded portion will be reported as tax-free income and the other 70% as long term capital gain.

If the gift annuity above were funded with \$10,000 in stock with a cost basis of \$3,000 rather than \$10,000 cash, the annuity payments would be taxed as follows.

### TAX BREAKDOWN OF ANNUITY:

	Capital Gain	Tax-free Portion	Ordinary Income	Total Annuity
2019 to 2019	43.87	18.80	18.20	80.87
2020 to 2031	336.35	144.15	139.50	620.00
2032 to 2032	90.67	38.86	490.47	620.00
2033 onward	0.00	0.00	620.00	620.00

If you compare this table with the one for the cash gift, you can see that the values in the Ordinary Income column have not changed, but the amounts in the Tax-free Portion column are now split between Capital Gain and Tax-free Portion columns.

If you add up all the capital gain amounts, the total reportable capital gain is \$4,170.74, not the donor’s \$7,000 gain in the stock. This is because the annuitant must report only the portion of the gain attributable to his investment in the contract. The portion attributable to the value going to charity is forgiven.

**Short term capital gain or ordinary income property:** The tax calculations for a gift annuity funded with short term capital gain property (property held one year or less) or ordinary income property is the same as for long term capital gain property. The only difference is that the portion that was taxed at long term capital gain tax rates will be taxed as ordinary income rates instead.

### Taxation of Charitable Remainder Trust Payments

Unlike the taxation of gift annuity payments, the taxation of CRT distributions is determined by the character of the income earned by the trust during its operation. The rules that govern how distributions from a charitable remainder trust are taxed are commonly referred to as the “four tiers of income” rules. The rules state that distributions made by a CRT must be characterized for tax purposes as follows:

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1. As ordinary income to the extent the trust has current ordinary income and past undistributed ordinary income.
2. As capital gain income to the extent the trust has current capital gain income and past undistributed capital gain income.
3. As tax-free income to the extent the trust has current tax-free income and past undistributed tax-free income.
4. As return of principal (not taxed).

### But wait, there's more . . .

IRS regulations make clear that the IRS holds the following view: within the ordinary income and capital gain income categories, income is treated as distributed from the classes of income in that category beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate.

As a result, the "four tiers of income" really look like "eight tiers of income:"

- Up to 37% - ordinary income
- 20% - qualified dividends
- Up to 37% - short term capital gain income
- 28% - capital gain income on sale of collectibles
- 25% - capital gain income on sale of real property that is attributable to depreciation recapture
- 20% - capital gain income on sale of securities
- Tax-free income
- Return of principal

Notice that because qualified dividends are taxed at a lower rate than three classes of capital gain income, it is possible for a CRT to distribute lower-taxed income before it distributes higher-taxed income. Strange, but true.

### Example:

A 5% charitable remainder unitrust is funded with stock the donor bought many years ago that is valued at \$100,000 and has a cost basis of \$20,000. The trustee sells the funding asset immediately, realizing \$80,000 in long term capital gain, then reinvests the proceeds in a diversified portfolio. At the end of the year, the trust has earned \$1,000 of qualified dividends and \$2,000 of interest but must distribute \$5,000 to the income beneficiaries. The income beneficiaries will have to declare their income as follows:

\$2,000 ordinary income (the interest income)  
\$1,000 qualified dividends  
\$2,000 long term capital gain income

Even though the trustee had to sell \$2,000 of assets at the end of the year to have enough cash to write the \$5,000 check, none of the distribution is return of principal. The trust must distribute all \$80,000 of the capital gain realized when it sold its funding asset (tier 2) before it can distribute any tax-free income (tier 3) or return of principal (tier 4).

## **IX. Tax savings**

We've reviewed in some detail how the charitable deduction is computed, but why do donors care about the charitable deduction? The charitable deduction is important because it enables the donor to save taxes.

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The amount of taxes the donor can save with a given charitable deduction depends on several factors. Let's consider a simple case first.

Imagine a married couple, the Smiths, with earned income of \$200,000 who make cash donations totaling \$25,000 for the year. Assuming they have no other deductions or sources of income, their charitable gifts will reduce their taxable income from \$200,000 to \$175,000. The federal income tax schedule for married couples filing jointly in 2019 is:

Taxable Income	Tax	% on Excess
\$0	\$0	10
19,400	1,940	12
78,950	9,086	22
168,400	28,765	24
321,450	65,497	32
408,200	93,257	35
612,350	164,709.50	37

The tax on \$200,000 of income would be  $\$28,765 + (200,000 - 168,400) \times 24\% = \$36,349$ .

The tax on \$175,000 of income would be  $\$28,765 + (175,000 - 168,400) \times 24\% = \$30,349$ .

Their \$25,000 in charitable deductions saves the Smiths \$6,000 in taxes. The Smith's highest tax bracket is 24%, which is known as their "marginal tax rate." Their tax savings from their deductions is at their marginal tax rate. In other words, their tax savings of \$6,000 equals  $\$25,000 \times 24\%$ .

### Factors that may affect the value of a donor's tax savings

Several factors can affect the amount of tax savings a donor can derive from a charitable gift that earns a given charitable deduction. While it is unlikely that you, the gift planner, will have enough information to assess whether any of these factors apply to a specific donor – and, regardless, your role is not to give tax advice – you should be aware of these factors and can be helpful to your donors by making them aware of them, too.

**Donor's marginal tax bracket:** As noted above, a donor who itemizes her deductions saves tax with her charitable deductions based on her marginal income tax bracket. It follows, then, that the higher a donor's marginal income tax bracket, the more tax she can save as a result of itemizing her charitable deductions. A married couple with taxable income over \$612,350 is in the 37% federal income tax bracket, which means they can save \$0.37 on every \$1 of charitable contribution they deduct. In contrast, a married couple with taxable income of \$100,000 are in the 22% federal income tax bracket, so they can save only \$0.22 on every \$1 of charitable contribution they deduct.

Most states that have an income tax also allow a deduction for gifts to public charities. For residents of these states, their marginal income tax rate for purposes of valuing their charitable deductions is a blend of their federal and state marginal income tax rates. You can't necessarily just add the two tax rates together to compute an aggregate tax rate, however, because the first \$10,000 of state and local income tax is deductible from federal taxable income. If a donor has less than \$10,000 of state and local income tax to deduct, you can just add the two marginal rates together. If a donor has more than \$10,000 of state and local income tax to deduct, the deduction against federal income tax will reduce the tax a little less than you might expect.

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Assume John Donor is in the 37% federal income tax bracket and an 8% state income tax bracket. His blended tax for determining his income tax savings from a \$10,000 charitable deduction would be:

$$\$10,000 \times ((1 - .08) \times .37) + .08 = \$10,000 \times .4204 = \$4,204$$

On the other hand, if Mr. Donor has more than \$10,000 in state and local tax deductions, he won't be able to deduct additional state tax from his federal income tax, so his income tax savings from a \$10,000 charitable deduction would be:

$$\$10,000 \times (.37 + .08) = \$10,000 \times .45 = \$4,500$$

**Standard deduction:** The standard deduction is the amount that taxpayers can choose to deduct when figuring out their taxable income without itemizing all their specific deductions. It makes sense for taxpayers to take their standard deduction rather than itemize their deductions if their total itemized deductions, such as charitable contributions, mortgage interest, and state and local taxes, would be less than their standard deduction.

The 2017 Tax Act that went into effect on January 1, 2018 roughly doubled the standard deduction to \$12,000 for single filers and to \$24,000 for married filing jointly filers. These amounts are indexed for inflation;

	Single filers	Married filing jointly filers
2019	\$12,200	\$24,400
2020	\$12,400	\$24,800

Of importance to planned gift donors, single filers age 65 or older may increase their standard deduction by \$1,650 and married filing jointly filers may increase their standard deduction by \$1,300 for each spouse age 65 or older. For these taxpayers, the standard deductions are:

	Single filers, 65+	Married filing jointly filers, both 65+
2019	\$13,850	\$27,000
2020	\$14,050	\$27,400

The 2017 Tax Act also eliminated some itemized deductions and capped the deduction for state and local taxes (sometimes called the SALT deduction) at \$10,000.

The combination of dramatically increasing the standard deduction and eliminating or capping some itemized deductions has caused the percentage of taxpayers who itemize their deductions to decline from about 30% in 2017 to about 10% in 2018.

**Here's the important point: taxpayers who take the standard deduction rather than itemize, and there are many more of them now than before 2018, save no taxes because of their charitable contributions.**

A planned gift donor who makes a gift that earns a large enough deduction will still want to itemize and will enjoy a tax benefit from the deduction as a result, but many donors who make a modest planned gift, such as a \$10,000 gift annuity that produces a charitable deduction of, say, \$5,000 - \$7,000, may be better off taking the standard deduction and therefore receive no tax benefit from their contribution.

**30%/50%/60% Deduction Limitations:** The deduction that a donor is allowed to claim in one year for gifts to a public charity is limited by the donor's adjusted gross income (AGI). Adjusted gross income is

## Planned Giving Calculations You Should Know

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the total of all a taxpayer's income from the year, earned and unearned, minus so-called "above the line" deductions, such as retirement plan contributions.

A donor is limited in how much in contributions to public charities she can deduct relative to her AGI, as follows.

- Cash gifts: 60% of AGI (increased from 50% in 2017 Tax Act)
- Long term appreciated property gifts: 30% of AGI
- Gifts of other property, such as short term appreciated property or ordinary income property: 50% of AGI

The donor may carry forward excess deductions of each type for up to an additional five years. In the context of planned giving, all gifts that earn an income tax deduction are subject to these limitations with the exception of the grantor lead trust. The grantor lead trust is subject to 30%/20% AGI limitations for gift of cash and long term appreciated property, respectively.

**Interaction of 60%, 50%, and 30% deduction limitations:** The way the 60%, 50%, and 30% AGI limitations interact is complicated, even more so than you might expect. Here goes.

Cash contributions reduce, dollar for dollar, the limit on 50% deductions taken in the same tax year, whether current gifts or carryforward. Sec. 11023(a)(G)(iii)(II). Cash contributions also reduce the 50% limit when considering the 30% limit on deductions for gifts of long term appreciated property. The result is that the only way a donor can deduct more than 50% of her AGI in charitable contributions is if the contributions deducted have been made entirely with cash.

### Examples

1. If a donor has an AGI of \$100,000 and makes \$40,000 of cash contributions and \$20,000 of long term appreciated property contributions, the donor can deduct all \$40,000 of her cash contributions, but only \$10,000 of her long term appreciated property contributions. Her deduction for long term appreciated property contributions is limited to \$10,000 because the 50% of AGI limit within which the 30% of AGI limit is applied has been reduced to \$10,000 by her \$40,000 in cash contributions ( $\$50,000 - \$40,000 = \$10,000$ ). Her total deductions will be \$50,000 and she will carry forward \$10,000 of 30% long term gain contribution.
2. If the same donor makes \$60,000 of cash contributions and \$20,000 of long term appreciated property contributions, she can deduct all \$60,000 of her cash contributions, but \$0 of her long term appreciated property contributions because her 50% limit has been reduced to \$0 by her \$60,000 in cash contributions. Her total deduction would be \$60,000 and she would carry forward \$20,000 in 30% long term gain contributions.

**Interaction of Deductions for Gifts to Public Charities and Private Foundations:** The 50% of AGI limit on contributions to public charities coordinates with the 30% of AGI limit on contributions to private foundations, a category that includes grantor charitable lead trusts, in a different way. In that situation, the 30% limit on contributions to private foundations is reduced to the extent the public charity contributions exceed 20%. Only after that is the reduction in the 30% private foundation limit dollar for dollar. Cash contributions under the new 60% limit are lumped in with other public charity contributions for this purpose.

### Example

If a donor with an AGI of \$100,000 makes \$10,000 in cash contributions and \$20,000 in non-cash contributions to public charities and \$30,000 in cash contributions to a private foundation, only \$20,000 of the cash contributions to the private foundation would be deductible in the year of gift. This is because the total contributions to public charities (\$30,000) exceeds 20% of the donor's AGI (\$20,000) by \$10,000, thereby reducing the donor's 30% limit on cash gifts to private foundations from \$30,000 to \$20,000. The donor would have to carry forward the remaining \$10,000 of cash contributions to the private foundation.

**Carry Forward from 2017 and Earlier:** Cash contributions to public charities from 2017 and earlier years that are carried forward into 2018 and later years continue to count toward the 50% limit and do not count toward the new 60% limit. Cash contributions to public charities carried forward during the 2018 to 2025 period into 2026 and later years go back into the 50% limit if the new 60% limit is not extended beyond its current expiration date of 12/31/2025.

### Reduction Rules

The reduction rules are federal income tax rules that reduce the amount of the charitable deduction available for gifts of certain kinds of property. Normally, the charitable deduction for a gift is based on the fair market value of the gift at the time of donation. The basic reduction rules say, however, that the deduction must be reduced by the amount of gain in the property that would not have been treated as long term capital gain if the donor had sold the property for its fair market value.

Property that is subject to the reduction rules include short term capital gain property (property held 12 months or less), inventory, and property subject to depreciation recapture. Since the capital gain in short term capital gain property is taxable as ordinary income, for example, the deduction available for a gift of short term capital gain property is based on the donor's cost basis in the property.

Another reduction rule requires a donor of tangible personal property to base his charitable deduction on his cost basis in the property unless the donee charity will put the property to a use that is related to the organization's charitable purpose. For example, a donor of an antique auto to an auto museum may base his deduction on the fair market value of the auto. If he were to donate the antique auto to a blood bank, however, he would have to base his deduction on his cost basis in the auto.

### Tax Benefits That Don't Depend on Full Deductibility

As we have seen, there are numerous ways in which tax rules can limit, or even eliminate, the tax savings from a charitable deduction. Two common sources of charitable gifts whose tax benefit does not depend on a donor itemizing charitable deductions are gifts of long term capital gain property, such as securities, and qualified charitable distributions from IRAs (aka, "charitable IRA rollovers").

**Contribution of Long Term Capital Gain Property:** The deduction for a contribution of long term capital gain property (property held by the donor for more than one year) is based on the fair market value of the property on the date of gift. What's more, the donor's capital gain in the charitable gift is forgiven. If the donor were to sell the property and give the proceeds instead, the donor would owe capital gain tax, which is 15% or 20% at the federal level.

### Example

A donor in the 32% federal income tax bracket and 15% federal capital gain tax bracket makes a \$100,000 outright gift to charity. He can make the gift with cash or stock with a cost basis of \$20,000.

## Planned Giving Calculations You Should Know

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### Give cash, sell stock

Deduction	\$100,000
Tax savings @ 32%	- \$32,000
CG tax on \$80,000 gain @ 15%	<u>+ \$12,000</u>
Net cost	\$80,000

### Give stock

Deduction	\$100,000
Tax savings @ 32%	- \$32,000
CG tax on \$80,000 gain @ 15%	<u>+ 0</u>
Net cost	\$68,000

The donor saved \$12,000 more in tax by giving the stock rather than cash. This savings didn't depend on the donor itemizing charitable deductions. What's more, if the donor likes the stock, he can repurchase it with the \$100,000 in cash he didn't give to charity, thereby resetting his cost basis in the stock to \$100,000 and eliminating capital gain tax on \$80,000 of gain should he decide later to sell the stock.

**A note about capital gain tax rates:** A widely overlooked change included in the 2017 Tax Act is the decoupling of federal income tax and federal capital gain tax schedules. Before the Act, the 10% capital gain tax bracket matched the 10% income tax bracket, the 15% capital gain tax bracket matched the 15% - 35% income tax brackets, and the 20% capital gain tax bracket matched the 39.6% income tax bracket. Easy, peasy. Not anymore.

Federal capital gains tax now follows its own tax brackets that are independent of federal income tax brackets. As an example, the brackets for a married couple filing jointly in 2020 will be:

### Capital gain tax

Taxable Income	Tax	% on Excess
\$0	\$0	0
80,000	\$0	15
496,600	62,490	20

### Income tax

Taxable Income	Tax	% on Excess
\$0	\$0	10
19,750	1,975	12
80,250	9,235	22
171,050	29,211	24
326,600	66,543	32
414,700	94,735	35
622,050	167,307.50	37

The 0% bracket matches closely the 10% - 12% income tax brackets for 2020, which will apply to \$0 - \$80,250 of taxable income. However, the 15% bracket ends in the middle of the 35% income tax bracket, which applies to \$414,700 - \$622,050 of taxable income. Naturally, the 20%

bracket also doesn't coincide with the 37% top income tax bracket, which applies to all taxable income above \$622,050.

**Charitable IRA Rollover:** The qualified charitable distribution from an IRA, widely referred to as a "charitable IRA rollover," is an increasingly popular way to make outright charitable gifts. There are several reasons for this trend. One is that the legislation that created the charitable IRA rollover was finally made permanent in 2015 after several rounds of temporary extension and possible expiration. Another is that the tax benefit of a charitable IRA rollover gift does not depend on the donor itemizing charitable deductions or otherwise being able to deduct fully the contribution.

Charitable IRA rollover requirements:

- Donation must be from a traditional or Roth IRA
- Donor must be at least 70 ½
- Gift must be outright – no benefits to the donor in exchange for the gift
- Recipient must be a public charity
- Gift can't be to a donor advised fund, supporting organization, or private foundation
- Withdrawal can count toward donor's required minimum distribution

A withdrawal from an IRA is fully taxable as ordinary income because the owner has never paid tax on contributions to the IRA, nor on the investment return earned inside the IRA. So, if a donor withdraws funds from an IRA and then donates them, the donor will have to declare the withdrawal as income and then hope that she can fully deduct the contribution in order to completely offset this income. If the donor doesn't itemize or otherwise is limited in her ability to deduct her charitable contributions, her gift will end up increasing her income tax.

In contrast, if a donor makes a qualified charitable distribution from an IRA, the withdrawal is not added to her taxable income. She doesn't get a charitable deduction, but she is guaranteed that the gift will not increase her income tax, even if she doesn't itemize her deductions. As an added benefit, her gift counts toward her required minimum distribution for the year.

So, if a donor wants to make an outright gift to your charity, has an IRA, and is 70 ½ or older, making the gift with a charitable IRA rollover up to the amount of the donor's required minimum distribution for the year is a great way to do it from a tax standpoint.

## X. 5% and 10% Tests

### 10% Remainder Interest Requirement

**Charitable remainder trusts:** The 10% minimum remainder value test requires charitable remainder trusts funded after July 28, 1997 to have a remainder value equal to or greater than 10% of the funding amount. That is, the deductible value of the CRT must be at least 10% of the funding amount of the trust.

As a practical matter, the 10% test rarely comes into play for charitable remainder unitrusts.

Examples assuming a 2.0% IRS discount rate:

- For beneficiary, age 60, CRUT % must be >15.0878% to fail 10% requirement
- For beneficiary, age 70, CRUT % must be >25.5207% to fail 10% requirement



## Planned Giving Calculations You Should Know

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In the case of charitable remainder annuity trusts, the very low IRS discount rate makes failure of the 10% test occur at more modest payout rates than for a CRUT, although still on the high side for typical beneficiary ages.

- For beneficiary, age 60, CRAT % must be  $>8.0117\%$  to fail 10% requirement
- For beneficiary, age 70, CRAT % must be  $>14.5872\%$  to fail 10% requirement

If you run calculations for a CRAT or CRUT that does fail the 10% deduction requirement, the solution is to decrease the payout rate or shorten the term of the trust. You can shorten the term by decreasing the number of beneficiaries, choosing older beneficiaries, or limiting it to a fixed number of years.

**Charitable Gift Annuities:** A charitable gift annuity also must have a charitable value that is more than 10% of the funding amount. Otherwise, the obligation of the charity to pay the annuity may constitute "acquisition indebtedness" or commercial-type insurance. Either may give rise to unrelated debt-financed income that is taxable to the charity.

- For beneficiary, age 60, CGA % must be  $>5.3384\%$  to fail 10% requirement
- For beneficiary, age 70, CGA % must be  $>7.5256\%$  to fail 10% requirement

The vast majority of charities that follow the suggested maximum rates published by the American Council on Gift Annuities rarely run into a problem with the 10% deduction requirement because the ACGA sets its rates so that they pass this test for IRS discount rates as low as a target value. All current ACGA rates pass down to an IRS discount rate of 2.8%. Even at today's rate of 2.0%, only rates for annuitants 45 or younger fail.

Similar to a CRAT or CRUT, the solution is to decrease the annuity rate or shorten the term of the annuity by decreasing the number of annuitants or choosing older annuitants.

### 5% Probability Test

A second test applies to a CRAT. If there is a 5% or greater chance of the trust principal being exhausted (used up) during its term, the IRS allows no charitable deduction. This probability test is outlined in Revenue Ruling 77-374.

The 5% probability test applies only to CRATs that will last for one or more lifetimes. The calculation of a CRAT's probability of exhaustion is a two-step process.

1. Determine how long the trust will take to exhaust its principal.
2. Determine the likelihood that at least one beneficiary will live that long.

The length of time it will take to exhaust the principal depends on the payout rate of the trust and the IRS discount rate. The IRS discount rate is the IRS's assumption of the investment return of the trust. If the IRS discount rate is less than the payout rate of the trust, then the trust will run out of money eventually. It's just a question of when.

For example, using November's IRS discount rate of 2.0%, a 5% CRAT that makes quarterly payments will exhaust in 25.5 years. Now, if the CRAT has one 70 year-old income beneficiary, what is the probability that 70 year-old will live more than 25.5 years. Consulting the 2000CM mortality table, it turns out that there is an 8.05% chance the 70 year-old will live that long, which means the CRAT fails the 5% probability test. The donor has a few choices:

1. Include a provision that the trust will terminate in favor of charity if the trust falls below 10% of its initial value plus 2% interest (Rev. Proc. 2016-42).
2. Choose an older income beneficiary.
3. Wait until a higher IRS discount rate is available.

If the CRAT's payout rate were greater than 5%, reducing the payout rate would be another option, but a CRAT is required to have a payout rate of at least 5% of its initial value, so reducing the payout rate would not be an option in our example.

It is worth noting that the very low IRS discount rate puts many CRATs in jeopardy of failing the 5% probability test.

## XI. Gift and Estate Taxation

**The American Taxpayer Relief Act (ATRA) was passed by Congress on January 1, 2013** to avoid the "fiscal cliff." This legislation capped a decade long patchwork of ever changing gift and estate taxation rates and exemptions. ATRA permanently unified the gift tax, estate tax, and generation skipping tax exemptions. ATRA set the transfer tax exemption amount at \$5.25 million per individual, \$10.5 million for married couples subject to inflation adjustment. The exemption amount for 2017 was \$5,490,000 per individual and \$10,980,000 for a married couple.

ATRA made permanent the portability of unused spousal gift tax and estate tax exemptions. This portability allows a surviving spouse to elect to use any unused exclusion remaining from his or her last deceased spouse. If a surviving spouse remarries and the new spouse subsequently dies, the surviving spouse then has access to the unused estate tax exclusion of the second spouse only. Portability is available only if an election is made on the deceased spouse's estate tax return.

In addition to being taxed during lifetime, prior taxable gifts are brought back into one's estate at death for purposes of calculating estate tax. A credit is given for lifetime gift taxes paid.

**The Tax Reform Act of 2017** increased the exemption equivalent amounts dramatically for 2018, raising the threshold to \$11,180,000 for an individual and \$22,360,000 for a married couple. Indexing for inflation occurs annually to these numbers, so the exemption equivalent amount in 2019 is \$11,400,000 per individual and \$22,800,000 for a married couple. These amounts will be \$11,580,000 and \$23,160,000, respectively, in 2020. This doubling of the estate tax exemption expires at the end of 2025 absent a change in the law. Until then, about 0.1% of all estates will be large enough to owe any estate tax.

### Calculation of a Taxable Transfer

- \$800,000 gift in 2000. No prior taxable gifts at the time and no others made prior to subsequent death.
- Death in 2019
- \$15,000,000 estate upon death.

**CALCULATING TRANSFER TAXES**

- 1. 800,000 Gift Made During Lifetime**
- 2. Settlement of \$15,000,000 Estate**

Estate in 2019	\$15,000,000
Prior taxable gifts	<u>+\$800,000</u>
Taxable estate	\$15,800,000
Tentative tax (from table below)	\$6,265,800
Less tax on \$11,400,000 estate tax exemption in 2019	<u>-\$ 4,505,800</u>
<b>Estate tax due in 2019</b>	<b>\$1,760,000</b>

**Gift and Estate Tax Rate Schedule in 2019**

<b>Taxable Transfer</b>	<b>Tentative Tax</b>	<b>% on Excess</b>
0	0	18
10,000	1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	40

**Unlimited Marital Deduction**

This deduction is for both inter vivos and testamentary transfers to a taxpayer's spouse. It allows spouses to pass property to each other free of federal gift and estate taxes. There are restrictions for spouses who are not US citizens and other restrictions that apply to terminable interests.

**\$15,000 Annual Exclusion**

Every taxpayer may give \$15,000 annually to each of any number of people without incurring any transfer tax. This exclusion applies only to gifts of a present interest, such as writing a check to a child or grandchild. As long as the check is for no more than \$15,000 (\$30,000 if given by a married couple). Gifts of future interests do not qualify for the exclusion. For example, if a father creates a gift annuity for himself and his son as consecutive beneficiaries, the gift to the son is a gift of a future interest and does not qualify for the \$15,000 exclusion.

## Planned Giving Calculations You Should Know

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The annual exclusion for gifts of a present interest has been indexed for inflation since 1999. The exclusion increases in \$1,000 increments. It was \$10,000 in 1999 and there have been five increases since then, the most recent one in 2018 (bringing the amount up to \$15,000).

### **Possible Income Tax Attributable to Transfers Made upon Death**

If a person was either the owner or beneficiary of an asset that would have been a source of payments taxed to her as ordinary income, then that asset features Income in Respect of a Decedent (IRD). If, upon death, others become entitled to receive these previously untaxed amounts, these payments constitute IRD to the recipients.

A distribution from an IRA made after the IRA owner has died is a common example of IRD. The only exceptions are distributions from a Roth IRA or distributions attributable to contributions of after-tax dollars made by the decedent to a traditional IRA or other non-Roth type of IRA. The same is true of distributions from most qualified retirement plans after the owner's death. In the case of certain commercial annuity contracts and savings bonds, some of what is distributed will be IRD, with the rest being non-taxable principal.

The good news for charities is that because of their tax-exempt status no income tax will be due on any IRD they receive. This means that if a donor's estate plan calls for benefiting both individuals and charities upon death, it is most efficient from a tax standpoint for the donor's estate to use IRD assets to make charitable gifts, avoiding the income tax that otherwise would be owed on these assets, and to earmark other assets for individuals.

### **Example**

Assume that \$1,000,000 of Mr. Soto's \$15,000,000 estate is from the balance in his qualified retirement plan. He can save \$350,000 in total taxes on his estate's assets by using the \$1,000,000 in his qualified plan to make charitable gifts and pass other assets to his son. His son is in the 35% income tax bracket.

<i>Estate tax</i>	<i>Give IRD to Charity</i>	<i>Give IRD to Son</i>
<i>Estate in 2019</i>	\$15,000,000	\$15,000,000
<i>Less charitable gifts</i>	- \$1,000,000	- \$1,000,000
<i>Prior taxable gifts during life</i>	+ 0	+ 0
<i>Taxable estate</i>	\$14,000,000	\$14,000,000
<i>Tentative tax</i>	\$5,545,800	\$5,545,800
<i>Less tax on 2019 exemption of (\$11,580,000)</i>	- <u>\$4,577,800</u>	- <u>\$4,577,800</u>
<i>Estate tax owed</i>	\$968,000	\$968,000

## Planned Giving Calculations You Should Know

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<b>Income tax</b>		
<i>Balance in qualified plan</i>	\$1,000,000	\$1,000,000
<i>Income tax deduction</i>	- \$1,000,000	- \$0
<i>Estate tax due on IRD</i>	- <u>\$0</u>	- <u>\$400,000</u>
<i>Taxable income</i>	\$0	\$600,000
<i>Income tax owed (son's rate=35%)</i>	\$0	\$210,000
<b>Total tax (estate tax + income tax)</b>	<b>\$968,000</b>	<b>\$1,178,000</b>

*Mr. Soto will save \$210,000 in taxes by making \$1 million in charitable gifts from his retirement plan rather than from other assets.*

Mr. Soto will save taxes by making his charitable gifts from his retirement plan rather than other assets *even if his estate is not large enough to pay estate taxes*. This is because all the tax savings comes from avoiding the income tax that would be due on the \$1 million in his retirement plan when his son withdrew it. In fact, his savings would be greater than in the example above because there would be no estate tax attributable to his retirement plan assets. As a result, all \$1 million in his retirement plan would be taxable income rather than “just” \$600,000 if he were to give this asset to his son. His son’s tax savings would be \$350,000 rather than \$210,000.

## **Appendix**

### **The General Theory of Discount Rate Relativity**

The IRS discount rate has dropped like a stone over the last six months. Last August it was hovering at 6.2%. By this February it had plunged to 4.2%. Commonly called the "rate of the month," rapid change in the IRS discount rate can play havoc with the deduction patterns that gift planners thought they understood. Just when it appears axiomatic that the deduction for a 5% remainder unitrust is always less than the deduction for a comparable 5% remainder annuity trust, the opposite becomes true. What is the cause? Blame the IRS discount rate.

Changes in the discount rate affect remainder annuity trust and gift annuity deductions far more than remainder unitrust deductions. Consequently, while annuity trust and gift annuity deductions bounce around with the discount rate, unitrust deductions change only slightly. Fortunately, a simple rule can help you predict the relationships among gift plan deductions, no matter what the current discount rate is. [For those of you with pooled income funds, changes in the discount rate don't influence pooled income fund deductions at all because each fund, once three years old, uses its own historical rate of return as its discount rate.]

#### **Rule of Thumb**

Here's the rule: When the payout rate of a remainder unitrust is greater than the discount rate used to calculate its deduction, the deduction for the unitrust will always be greater than the deduction for a comparable remainder annuity trust or gift annuity. Likewise, if the payout rate of a remainder unitrust is less than the discount rate used to calculate its deduction, its deduction will always be less than the deduction for a comparable remainder annuity trust or gift annuity.

The larger the gap between the payout rate and the discount rate, the larger the difference in deductions will be. It should come as no surprise, then, that when the payout rate equals the discount rate, the unitrust, annuity trust and gift annuity all yield the same deduction (actually, the unitrust deduction will deviate slightly if payments are not made annually at the end of each period). Call it the General Theory of Discount Rate Relativity.

#### **An Example**

Let's put the Theory to the test: Let's examine what happens to the deductions available for a \$100,000 gift paying quarterly to a 76-year-old income beneficiary. The table below compares deductions computed using a 6.2% IRS discount rate and a 4.2% IRS discount rate.

### Deduction Comparison

<b>Gift Type</b>	<b>IRS Rate = 6.2%</b>	<b>IRS Rate = 4.2%</b>
5% Unitrust	\$62,647	\$62,327
5% Annuity Trust	\$64,725	\$60,448
5% Gift Annuity	\$64,725	\$60,448

You can see that over the same change of discount rate, the unitrust deduction shrinks only modestly from \$62,647 to \$62,327, while the deduction for a similar annuity trust or gift annuity declines substantially from \$64,725 to \$60,448. As predicted by the Theory, when the IRS discount rate is lower than the payout rate of the gift plan, the unitrust deduction is higher than the deduction awarded the annuity trust or gift annuity, and when the IRS discount rate is higher than the payout rate, the opposite pattern holds true.

### **Why the Theory Works**

Why does the Theory work out this way? The answer lies in how the payments of each gift plan are determined. In the case of a gift annuity or annuity trust, payments are fixed at the outset, so if there is growth in the gift assets, all of that growth goes to the charity when the gift plan terminates. In contrast, the income beneficiaries and charity share the benefit of any growth in unitrust assets, since the income payments will increase as the trust assets grow. Similarly, the charity bears the entire cost of a decrease in asset value with a gift annuity or annuity trust but shares the cost with the income beneficiaries in the case of a unitrust.

Now, think of the discount rate as the annual rate of return that the IRS assumes the gift assets will earn in the future. For example, a discount rate of 5% means the IRS thinks gift assets will earn an annual rate of return of 5%. As a result, if the payout rate of the gift plan is less than 5%, the IRS will predict that the gift assets will grow over time. Knowing this, you can see before you even turn on your computer that the gift annuity and annuity trust will earn higher deductions than the unitrust. Why? Because the IRS expects the charity to receive more money with the annuity trust and gift annuity than with the unitrust.

### **What About Lead Trusts?**

The Theory works for lead annuity trusts and lead unitrusts, too, but the relationships are reversed: when a lead unitrust's payout rate is greater than the discount rate, the unitrust's deduction will be smaller than a comparable lead annuity trust. This makes sense, since in this situation the IRS predicts that the lead unitrust will shrink over time, causing its payments to charity to shrink, too. The lead annuity trust payments are fixed, of course, so the amounts going to charity will not shrink as the trust's principal declines. Since most lead trusts are lead annuity trusts, the decline of the IRS discount rate should improve the popularity of lead trusts overall.

### **Conclusion**

Although the deduction is only one of many considerations that go into a gift plan decision, think about the General Theory of Discount Rate Relativity the next time you are trying to decide what gift plan to recommend to a prospect. It may save you some time. The Theory will also come in handy when a prospect asks you why his or her deduction has changed between illustrations or why deductions differ among gift types.