
FINANCIAL STRATEGIES

For estate planning and planned giving.

- Legislation
- Court decisions
- IRS developments

UNIVERSITY OF ROCHESTER

Spring 2008

FALLING INTEREST RATES IMPACT CHARITABLE PLANNING

Interest rates have dominated the news in recent weeks as the Federal Reserve Board has initiated significant cuts. Although such rate cuts are calculated for purposes such as stimulating the economy and staving off recession, they do have a substantial—if not completely intended—impact on charitable planning.

When charitable planning vehicles create both charitable and noncharitable interests in the same property, the amount of the allowable deduction for the charitable portion of the transaction is determined according to a formula that takes into account a number of factors, including the prevailing discount rate determined under IRC §7520.

This discount rate changes from month to month and is calculated at 120% of the average federal midterm rate in effect under IRC §1274(d)(1). The federal midterm rate is the

interest rate on outstanding marketable obligations of the United States government with maturity periods greater than three years but not over nine years. The exact rate that results is rounded to the nearest .2%.

This rate is sometimes referred to as the charitable federal midterm rate (CFMR) and has been calculated according to this method since 1988. It is used for valuing any annuity, any interest for life or a term of years, and any remainder or reversionary interest. **Note:** If a charitable income-, estate-, or gift-tax contribution is allowed for any part of a transfer of property subject to valuation under IRC §7520, the taxpayer may elect to use the discount rate for the month of the transaction or either of the two months prior.

Falling Rates: The Domino Effect

Even though the actions of the Federal Reserve Board do not directly determine the rates on federal midterm obligations, they generally cause other rates to move in the same direction. As the Fed has reduced the federal

funds rates, rates on most other obligations have followed suit.

The Federal Reserve cut rates from 5.25% to 4.75% in September of 2007—the first rate cut in more than four years. Since that time it has further reduced rates, and those reductions have been reflected in the rates on the federal obligations that determine the CFMR under IRC §7520. As recently as August of 2007, the CFMR was 6.2%. By March of 2008, it had dropped to 3.6%.

Charitable Federal Midterm Rates		
Year	Month	Rate
2007	August	6.2%
2007	September	5.8%
2007	October	5.2%
2007	November	5.2%
2007	December	5.0%
2008	January	4.4%
2008	February	4.2%
2008	March	3.6%

What does this drop in the CFMR mean to someone contemplating a split-interest charitable gift? In general terms, a drop in the discount

rate increases the value of an income interest and reduces the value of a remainder interest. The deductible portion of a split-interest gift may be either a present or future interest, depending on the type of gift plan utilized.

Rate-Cut Winners

Charitable lead trust. The type of charitable planning strategy that may benefit the most from a decline in the CFMR is a charitable lead trust. With this type of vehicle, a designated charity (or charities) receives an income interest in trust assets for a specific period of time or for the lifetime(s) of named beneficiary(ies).

This income—or lead—interest can take the form of either a fixed annuity amount or a unitrust amount based on the annual value of the trust assets. In either case, the actuarially determined present value of that lead interest qualifies for a charitable deduction.

That deduction can be an income-tax, a gift-tax, or an estate-tax deduction, depending on the specific type of charitable lead trust utilized. The choice, in turn, depends on the planning objectives of the donor.

In the case of an inter vivos trust, the donor will qualify for a charitable income-tax deduction if he or she creates or retains any interest in the trust that causes it to be a grantor trust—most typically reversionary rights. If the donor gets a charitable income-tax deduction, he or she must then remain taxable on the trust's income during the trust term.

A much more common objective, though, for donors contemplating a charitable lead

trust is to generate a gift- or estate-tax deduction that can reduce—or even eliminate—the tax on the transfer of assets. With such nongrantor trusts, the donor does not get a charitable income-tax deduction and is not taxable on the trust's income. In addition, the donor gets to subtract the present value of the charity's lead income interest from the total value of the trust's initial assets in determining what part—if any—of the trust's value is subject to gift or estate tax.

Example: George B would like to make a significant gift to our organization and also reduce the federal transfer tax on some assets that will pass to his children. He puts \$2,500,000 into a nongrantor charitable lead annuity trust that will pay us \$175,000 annually for the next 20 years. At the end of the trust term, the remaining trust assets will be distributed in equal shares to his children.

Using a 3.6% CFMR, our lead income interest is worth \$2,464,825. This means that only the balance of the trust assets—or \$35,175 (\$2,500,000 - \$2,464,825) is treated as a taxable gift to George's children subject to federal gift tax. Assuming George has at least this much of his \$1,000,000 lifetime gift-tax exemption available, he will owe no current tax.

If the trust achieves a total return of 8% per year during the term of the trust, there will be \$3,644,049 remaining to distribute to George's children—all with no additional gift or estate tax.

If George had made such a gift in August of 2007 when the CFMR was 6.2%, the results would have been significantly different. Because of the higher discount rate, the charitable income interest would have had a present value of \$1,975,050. The taxable portion of the transfer would have been \$524,950. This would have increased the amount that ultimately gets added to George's gross estate at his death as taxable lifetime gifts by \$489,775 (\$524,950 - \$35,175).

The Tax Relief Act of 2001 Impact on Estate and Gift Planning

The uncertainty surrounding the eventual fate of the estate tax requires constant vigilance. Fewer estates are affected by the federal estate tax because of the dramatic changes brought about by Tax Relief 2001 (see chart at right). The tax is repealed for the year 2010—but it will be back at 55% in 2011 with an exemption of \$1 million unless repeal or higher exemption amounts are re-enacted prior to that time.

Rate and Exemption Schedule		
Calendar Year	Exemption	Highest Tax Rate
2008	\$ 2 Million	45%
2009	\$3.5 Million	45%
2010	Estate Tax Repealed	
2011	\$ 1 Million	55%

Historically, the CFMR has been as high as 11.6% and as low as 3.0%. This chart shows the portion of a \$2,500,000 charitable lead annuity trust that pays \$175,000 (7%) to charity for 20 years that qualifies for a gift- or estate-tax deduction at various discount rates:

\$2,500,000 Charitable Lead Trust		
CFMR	Deduction	% of Total
9%	\$1,597,500	63.900
8%	\$1,718,175	68.727
7%	\$1,853,950	74.158
6%	\$2,007,225	80.289
5%	\$2,180,875	87.235
4%	\$2,378,300	95.132
3%	\$2,500,000	100.000
7% payout for 20 years		

Retained life estates. Another charitable strategy that benefits from lower interest rates is a gift of a remainder interest in a farm or personal residence with a retained life estate. The donor in such an arrangement is allowed an income-tax deduction for the value of the charity's remainder interest.

As we have seen above, lower interest rates tend to increase the value of an income interest because the income has more relative value compared to a lower discount rate. In the case

of a retained life estate, the value of that life estate is directly proportional to the current discount rate. Therefore, when the interest rates go down, the value of the retained life estate goes down and the value of the remainder interest goes up.

Example: Hal and Linda, both 72, contribute a remainder interest in their home to our organization and retain a life estate for their joint lives. The value of their home is \$500,000.

At a 3.6% discount rate, the deductible value of the remainder interest is \$233,455. If they had made the gift in August of 2007 when the discount rate was 6.2%, the deductible value of the remainder interest would have been \$163,295.

Impact on life-income gifts. Lower interest rates generally have the effect of lowering the deductible portion of life-income gifts such as charitable gift annuities, charitable remainder annuity trusts, and charitable remainder unitrusts.

The effect varies, though, depending on the type of gift. With both charitable gift annuities and charitable remainder annuity trusts, the impact is fairly significant. Charitable remainder unitrusts (CRUTs) are affected less, however, since the amount paid annually from a CRUT reflects the changes in the annual value of the trust. With a lower discount rate, a CRUT would be assumed to grow less and thus pay out less.

The following chart shows the deductible portion of a \$100,000 contribution for a charitable gift annuity (CGA), charitable remainder annuity trust (CRAT), and CRUT that pays 6% annually for life to a 65-year-old beneficiary at representative discount rates:

Deductible Portion of \$100,000 Gifts			
CFMR	CGA	CRAT	CRUT
9%	\$51,740	\$51,740	\$41,558
8%	\$48,428	\$48,428	\$41,375
7%	\$44,678	\$44,678	\$41,190
6%	\$40,415	\$40,415	\$41,004
5%	\$35,529	\$35,573	\$40,815
4%	\$29,908	*	\$40,624
3%	\$23,396	*	\$40,431

* Does not qualify as a charitable remainder trust because there is a greater than 5% probability that the corpus will be depleted during the trust term.

E-Mail Discussion Lists for Gift Planners

- **ABA-TAX** A tax-law Internet discussion group sponsored by the American Bar Association Tax Section. Participation is limited to practitioners, law professors, and law students. <http://www.abanet.org/tax/linfo.html>
- **ABA-PTL** Sponsored by the Probate Division of the Real Property, Probate & Trust Law Section of the American Bar Association, intended primarily for the use of Section members and related professionals so they can discuss estate-planning and administration issues by e-mail. <http://mail.abanet.org/scripts/wa.exe?SUBED1=aba-ptl&A=1>
- **FUNDSVCS** Fundraising services technical discussion list. <http://lists.duke.edu/archives/fundsvcs.html>
- **Yahoo PLANNED GIVING** An open list for discussion of gift-planning topics. <http://groups.yahoo.com/group/plannedgiving/>
- **GIFT-PL** National Committee on Planned Giving members-only discussion list for all issues and queries related to gift planning. http://www.ncpg.org/members/gift_pl.asp?section=4

BRIEFLY...

Inadequate records cost

taxpayer deduction. A Maryland taxpayer's claims of substantial charitable deductions have been denied by the Tax Court due to woefully inadequate or missing documentation produced by the taxpayer at trial (*Akin Falodun v. Commissioner*; T.C. *Summ. Op.* 2008-5; No. 16424-055).

The taxpayer claimed almost \$13,000 in charitable contributions for the 2003 tax year, consisting of gifts by check or cash of \$4,356 and gifts other than by checks or cash of \$8,565. Although he did file a Form 8283 with his tax return, the taxpayer provided extremely abbreviated information about the claimed contributions and the method he used to determine their fair-market value.

In regard to the cash gifts, he introduced only one receipt for \$50 into evidence but asserted a claim of making multiple gifts by check or cash to his church and other charities. Exercising its discretion to estimate the amount of such gifts under *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), the court allowed a total of \$250.

The taxpayer produced several receipts for noncash gifts but acknowledged having filled most of them out himself, describing the condition of the property as "new" or "excellent" in many cases. Again the court exercised its discretion and allowed a total of \$250 for noncash gifts. On an issue not related to charitable deductions, the court also disallowed a claim of \$10,348 for unreimbursed mileage expense for more than 28,000 miles of traveling between the taxpayer's full-time job and a part-time job.

IRS allows early CRT termination to settle estate litigation. The Internal Revenue Service has ruled that the early termination of a CRAT to settle estate litigation is not an act of self-dealing (Ltr. Rul. 200802032 and 200802033).

A dispute arose between the personal representative of an estate and the decedent's only child, who was also the sole noncharitable beneficiary of a testamentary CRAT. The personal

representative, also the trustee of the CRAT, alleges that the child misappropriated funds rightfully belonging to the decedent's estate. All parties, including the charitable beneficiaries, agreed that further litigation will result in dissipation of the assets of the CRAT to the detriment of all.

The parties have reached a compromise and have asked the IRS to approve a plan under which the estate will distribute funds to the CRAT, which in turn will distribute most of those assets to a liquidating trust for the benefit of the charitable remainder beneficiaries. The balance will be distributed to the child.

The IRS cited *Rockefeller v. United States*, 572 F. Supp. 9 (E.D. Ark. 1982) for the proposition that if a private foundation has no interest or expectancy with respect to any specific property, there is no context in which a self-dealing transaction might arise. That applies in this case, according to the IRS, because each party is viewed as receiving the assets and property she or it was entitled to receive when the terms of the will became final.

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

UNIVERSITY OF
ROCHESTER

590 Mt. Hope Avenue
Rochester, New York 14620
(585) 273-5930
toll free (800) 635-4672