Gift Planning Now

A Newsletter for Berkeley's Donor Advisors

Fall 2014

Charitable Planning for Estates Not Subject to Federal Estate Tax

Now that estates up to $5.34 million* are not subject to federal estate tax, will any charitable tax strategies be needed by the vast majority of donors? Are lifetime contributions now even more attractive than testamentary transfers? What other rewards may be available for philanthropic individuals who don't have to worry about federal estate taxes?

Inheritance/state estate tax savings. A total of 19 states and the District of Columbia currently impose estate or inheritance taxes. Furthermore, real estate and tangible personal property that donors own outside their home states may be taxable under a variety of rules and rates (vacation homes and their contents may be a particular concern). All states with estate taxes offer charitable deductions or exemptions that encourage charitable bequests.

Tax-burdened assets. Income in respect of a decedent (IRD) will continue to be an issue for beneficiaries of estates, even if federal or state estate taxes are not a concern. Donors can be encouraged to leave retirement accounts, U.S. savings bonds and other items of IRD outright to charity, thereby avoiding completely the deferred income tax on those assets. Testamentary charitable remainder trusts funded with IRAs or savings bonds could provide lifetime income to a loved one without immediate erosion from taxes.

Nontax considerations. Donors who wish to benefit both charities and family members may be attracted to charitable remainder trusts or charitable gift annuities because of the money management or trusteeship services these vehicles provide to their beneficiaries. If gift arrangements are established during life, they also avoid probate and reduce income taxes.

Lifetime gift arrangements. Under the federal estate tax, married persons generally receive no estate tax advantage from charitable bequests made when the first spouse dies because marital transfers can be sheltered 100% by the estate tax marital deduction. Couples, accordingly, are better advised to make lifetime contributions where feasible – including charitable remainder trusts and gift annuities – and enjoy income tax savings, capital gains tax avoidance or reduction and current recognition from charitable organizations.

Donors can also include the power to accelerate bequests in their durable powers of attorney.

* This amount increases to $5.43 million on 1/1/2015.

Our Newest Bears: 2014-15 Incoming Students

As we focus on the excellence of undergraduate education at Berkeley, a whole new population of undergraduates has been welcomed to campus this fall: our youngest transfer student is age 15 and the eldest is age 75; 69% of incoming freshmen come to us from public high schools; 80 new students have prior military experience; 5,800 are new freshmen; and 2,500 are new transfers. Read more at newscenter.berkeley.edu/2014-2015-incoming-student.

Charitable Planning for Taxable Estates

Even with the greatly increased estate tax exclusion amount, some individuals will still need to include estate tax considerations in the context of their charitable giving. With careful planning, the estate tax charitable deduction may enable donors to increase the amounts they leave to organizations, especially where charitable remainder trusts and lead trusts are employed. Common strategies include:

Maximizing estate tax charitable deductions. Estate tax deductions are available only for amounts actually passing to charity. When the dispositive provisions of a will include percentage distributions to charities and individuals, the provisions can direct that no estate taxes or costs of administration are payable from the charitable bequests.

Selecting bequest assets. Donors who face federal estate tax should consider bequests of IRD assets that additionally save income taxes for their estates or beneficiaries (see previous discussion).

Alternative charitable bequests. Charities can be named contingent beneficiaries in the event a named beneficiary predeceases the donor, or disclaims part or all of a bequest. Disclaimers allow a family beneficiary who feels he or she does not need all that a testator has provided to pass along all or part of a bequest to a worthwhile cause named by the testator [Code §2518(c)] – and also provide tax savings to the estate, especially if the bequest that is

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UC Berkeley Planning Pointer:

Why Interest in Charitable Remainder Trusts Is Growing

There is renewed interest among many donors in creating charitable remainder trusts (CRTs) or, for those who already have a CRT, in making an addition to their trust. When establishing a CRT with a charitable organization, the donor makes an irrevocable gift to charity of the remainder value of the trust while also creating an income stream for life (or a term of years not to exceed 20) for themselves or loved ones. The most common type of CRT, a charitable remainder unitrust, bases the dollar amount of annual income payments on the value of the trust assets as revalued annually, e.g., a fixed 5% of the value of the trust assets each year.

The stock market and many local real estate markets have experienced remarkable gains over the last several years. Accordingly, many donors have securities and real estate holdings with large built-in capital gains and are wondering how best to deal with those gains. They may also want to diversify these parts of their portfolios. One key tax benefit of a CRT is that no capital gains tax is due at the time the assets are transferred to the trust. Thus, the full value of the assets is invested in the trust, rather than a value reduced by payment of capital gains tax. The higher the trust asset value, the larger the income payments, since the income stream for the donor or loved one is based on the value of the trust assets.

In addition, new income and capital gains tax rates took effect for many individuals at higher income levels under the American Taxpayer Relief Act of 2012 (effective 1/1/2013), as did new income and sales tax rates under California's Proposition 30 (effective 1/1/2012). These increased rates, combined with the new tax on "net investment income" under the Affordable Care Act effective January 1, 2013, brings the federal capital gains rate to 23.8% for some individuals. That federal rate combined with a high state capital gains rate like California's can bring the total capital gains tax rate for high-income individuals to 35% or more.

Finally, as longevity rates increase, a charitable remainder unitrust can provide a good hedge against inflation since the trust payments have the ability to increase over time as the value of the trust assets increase.

For all of these reasons, as well as others in individual cases, now may be a good time to talk with clients about the possibility of creating a charitable remainder trust to benefit themselves or loved ones, as well as the programs at their favorite charity that mean the most to them.

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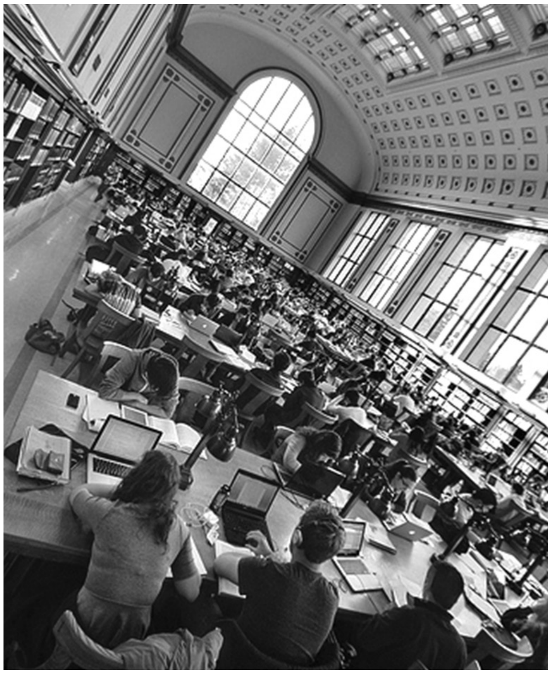
disclaimed is IRD.

Charitable bequests in trust. A charitable bequest can be deferred until the death of a decedent's beneficiary – that is, a family member or other loved one can receive lifetime income from the bequest property, remainder to charity. This can be accomplished by means of a testamentary or inter vivos charitable remainder trust. A "deferred bequest" can be made through any form of trust if an estate tax charitable deduction is not important. A testamentary charitable lead trust can make annual payments to charity for a term of years and ultimately pass the remaining trust principal to family beneficiaries, with significant estate tax savings.

Planning for married donors. A spouse's interest in a testamentary charitable remainder trust will qualify for the unlimited estate tax marital deduction, if properly planned [Code §§2056(b)(7), (8)]. Another option is a qualified terminable interest property (QTIP) trust with charity as remainderman, which can generate a 100% estate tax marital deduction when the first spouse dies [Code §2056(b)(7)] and a 100% estate tax charitable deduction at the death of the surviving spouse [Code §§2044(c), 2055]. This is a simple, flexible arrangement that permits a testator to provide for a spouse, yet ultimately benefit charity. A testamentary charitable remainder unitrust for a surviving spouse might be preferable if the trust will be funded with IRD.



Dueling Will Provisions Interpreted

The importance of precisely describing what constitutes "tangible personal property" when working with clients who are artists or others who create tangible personal property was highlighted in the will of fashion photographer Francesco Scavullo. In his will, Scavullo left half of his collection of photos, negatives and transparencies to fund a charitable foundation in Scavullo's name. He left "the balance of my tangible personal property" to a friend, Sean Byrnes. Later in the will, Scavullo provided that the remaining half of his photos, negatives and transparencies was to fund a trust. Income from the trust was to be paid to Byrnes for life, with the remainder passing to the foundation. Byrnes argued that he was entitled to half of the photo collection outright, rather than in trust.

The Surrogate's Court of New York said it was clear that the same property could not be bequeathed both outright and in trust. Therefore, a canon of will construction provides that a prior will provision generally gives way to a later provision. The court found Scavullo's general intent had been to provide for Byrnes partly outright and partly in trust. It was likely, said the court, that Scavullo used the phrase "tangible personal property" more broadly at one point and more narrowly at another (*In re Scavullo*, 2014 NY Slip Op. 31848(U)).

Tax Planning Pointer

A donor who has an outstanding pledge to charity might think that the creation of a charitable remainder trust, with the remainder earmarked to satisfy the pledge, is the ideal solution. However, the IRS has consistently taken the position that the use of a charitable remainder trust to satisfy the grantor's legal obligations violates the private foundation rules and is an act of self-dealing [Reg. §53.4941(d)-2(f)(1)]. The same is true where the income payments are used to satisfy the donor's non-charitable obligations (e.g., alimony, child support).

From Like-Kind Exchange to Unitrust

Many real estate investors are familiar with the like-kind exchange provisions of Code §1031. These rules allow taxpayers to postpone capital gains tax on the disposition of a piece of income-producing or investment real estate by "trading" or exchanging for another parcel of similar use. While these deferral opportunities can be highly deliverable for a period of time, at some point real estate investors often want to go in another direction.

Take the example of Warren, who owns a small apartment building near his home in California. He originally paid $250,000 for the property years ago, but has since depreciated it down to $50,000. He estimates that it is now worth $900,000. Warren recently retired and will be moving to Nevada within the next few months. Because he will no longer be able to keep an eye on the apartment, he would like to sell it. If he does, however, he'll be hit with a substantial capital gains tax.

One option for Warren is to defer recognition of capital gain by means of a like-kind exchange. How would it work? Warren could identify rental real estate that he wishes to acquire in Nevada. Because it's unlikely the owner of the Nevada property would want to exchange it for California real estate, Warren would have to persuade the potential buyer of his California property instead to purchase the Nevada real estate he wants to acquire. The two could then "trade" parcels. Warren would keep the same basis in his new property that he had in the California building, with adjustments for other property, such as cash, that changed hands.

An even easier method for Warren to postpone the capital gains tax is through a Starker-delayed exchange [Code §1031(a)(3)]. He could sell his California property and arrange to have the proceeds held by an intermediary (e.g., trust department of a bank). He would have 45 days to designate the replacement property in Nevada and 180 days to close on that property.

But what happens to Warren and the thousands of other real estate investors when they finally decide to get out of the real estate business? Several like-kind or Starker exchanges may have taken place over the years, leaving the taxpayer with a low or zero basis in property with a highly appreciated fair market value.

Philanthropic clients faced with this dilemma could find that a charitable remainder unitrust is the solution to several problems. First, there is no capital gains tax when the real estate is transferred to the trust or sold by the trustee. Second, there is a charitable deduction based on the fair market value of the property, not the client's often much lower adjusted basis. Third, the client receives income payments over his or her life, so the cash flow can replace some or a lot of the rental income the client previously received. Fourth, rather than receiving rent, which is ordinary income, a significant portion of each year's trust payments are typically capital gains income.

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