Section 7520 rates have been below 5% since the beginning of 2008, currently hovering at 1.6%. That's bad news for donors wishing to fund charitable remainder annuity trusts. Not only are annuity trusts subject to the same 10% remainder requirement as charitable remainder unitrusts [Code §§664(d)(1)(D), (d)(2)(D)], they are also subject to a 5% probability test [Rev Ruls. 70-452 and 77-374]. No deduction is allowed for a charitable remainder annuity trust if the probability exceeds 5% that a noncharitable beneficiary of the trust will survive to the exhaustion of the trust fund. An annuity trust for which a deduction is not available is not a qualified charitable remainder trust [Letter Ruling 9532006].

The 5% probability test is not really an issue when §7520 rates exceed 5% and the trust provides for the minimum 5% payout, but the lower the rates, the more difficult it is for annuity trusts to satisfy the probability test. For example, a 5% one-life annuity trust, assuming quarterly payments and a 1.6% §7520 rate, does not qualify for a donor age 73, although the charitable deduction of more than 45% easily satisfies the 10% remainder requirement. For a two-life annuity trust, both income beneficiaries would have to be at least age 75 to pass the 5% test.

(continued on page 2)
IRS Extends Annuity . . . (continued from page 1)

Recently released Revenue Procedure 2016-42 offers a possible solution for younger donors seeking the fixed payments of an annuity trust. Annuity trusts created on or after August 8, 2016, that include the exact language of the sample provision will not be subject to the 5% probability test. The provision calls for the early termination of the annuity trust and an outright distribution of trust assets to the charitable beneficiary(ies) prior to the date on which an annuity payment would be made, if that payment would result in the value of the trust corpus falling below 10% of the value of the initial trust corpus. The early termination is considered a qualified contingency under Code §664(f). Language is included for both inter vivos and testamentary annuity trusts.

The Revenue Procedure includes an example in which the donor, on January 1, transfers $1 million to a 5% annuity trust, with $50,000 payments to be made each December 31 and using a §7520 rate of 3%. Each year, the trustee is required to determine whether the value of the trust corpus, minus the $50,000 payment multiplied by a specified discount factor, is greater than $100,000 (10% of the initial value of the trust). The computation qualifies in each of the first 17 years. The value of the trust corpus as of December 30 in year 18 is $210,000. The computation is as follows:

1. $1,000,000 x 10% = $100,000
2. ($210,000 - $50,000) x [1/(1 + .03)]^18
$160,000 x (1.03)^18
$160,000 x 0.970874
$160,000 x 0.587397 = $93,984

Because the value of the trust corpus minus the $50,000 payment, multiplied by the discount factor, is less than $100,000, the trust terminates on December 30 of year 18 and the principal and income – including the annuity payment that would otherwise have been payable to the income beneficiary – is distributed outright to charity.

Should donors be concerned about their annuity trusts ending early? While that is a possibility, trustees are likely to be able to get returns higher than what is presumed under current §7520 rates. Therefore, it may not be necessary to dip into corpus to the point where the 10% remainder value is reached.

UC Berkeley Planning Pointer:

A Year-end Gift Annuity May Be a Smart Bet

Stock markets have been on a tear this year. While that’s a good sign for investors, it may leave some concerned about losing that appreciation in any significant market dip. One possible solution is to lock in gains by selling some shares, but then clients have to pay a portion of that appreciation to the IRS. For most taxpayers, the federal capital gain rate is 15%, but for a few, it’s 20%, or even 23.8% with the net-investment income tax.

Charitable gift annuities offer an alternative for philanthropic investors. Gift annuities are a simple and highly effective way for a client to make a generous gift to charity and be assured of dependable and tax-favored payments for life, based on the full fair market value of the shares. A portion of the capital gain is avoided outright, with the balance spread over the donor’s life expectancy. Gift annuity rates range from 4.4% at age 60 to 9% at age 90 or older. Rates are slightly lower for two-life gift annuities.

Consider the financial advantages for a client, age 72, with $50,000 in stock for which the client originally paid $25,000, assuming a 1.4% §7520 rate and quarterly payments:

Annual payments of $2,700 (5.4%)
- $1,073 of which is tax free for 14.5 years
- $1,074 of which is favorably taxed capital gain for 14.5 years
- $553 of which is taxed as ordinary income
Charitable deduction of $18,857

Factoring in the benefit of the charitable deduction (a tax savings of $5,280 in the 28% income tax bracket) and the tax-free income (equivalent to a taxable yield of $1,490), the donor’s benefit is even higher than the 5.4% gift annuity payout rate.
Three Good Reasons to Make Outright IRA Gifts

Part of any year-end financial review with clients over age 70½ should include a discussion on required IRA distributions and the option for making qualified charitable distributions (QCDs). IRA owners ages 70½ and older may make direct gifts to charity of up to $100,000 annually [Code §408(d)(8)]. These gifts are tax-free and can satisfy required minimum distributions. There are several reasons why a QCD might be attractive to eligible clients:

1. Tax savings are available, even for clients who don’t itemize deductions – Although no charitable deduction is allowed for QCDs, if the gift takes the place of required minimum distributions that would otherwise be fully taxed, the donor saves income tax.

2. Reducing taxable income may yield other savings – Reductions in itemized deductions and personal exemptions may be reduced if the client directs that required minimum distributions instead go to charity. The client could avoid the 3.8% net-investment income tax [Code §1411] that applies to taxpayers with modified AGI in excess of $200,000 (singles) or $250,000 (couples). A QCD could also keep a client out of the top 39.6% income tax bracket and the 20% rate on capital gains.

3. Future estate taxes may be reduced or eliminated – Clients can reduce large IRAs by making a series of annual $100,000 gifts. This may also serve to lower required minimum distributions in subsequent years.

Benefiting Family and Berkeley with IRAs

There are options for clients to use IRAs and other qualified retirement plans to benefit both family members and charitable organizations, while also avoiding the tax on income in respect of a decedent or IRD [Code §691(a)(1)].

Charitable remainder trusts – A testamentary charitable remainder trust can be named the beneficiary of an IRA, with a surviving spouse (Letter Ruling 9253038) or a child (Letter Ruling 9237020) designated as the life income beneficiary. There is no IRD tax at the time the IRA monies fund the charitable remainder trust. The trust also prevents IRA assets from being dissipated quickly and can shift investment management of the assets to a trustee. When the trust terminates, one or more charitable organizations receive the remaining assets.

Charitable gift annuities – The IRS has ruled favorably on an IRA passing to charity in exchange for a charitable gift annuity to be paid to a named individual (Letter Ruling 200230018). The annuity amount will depend on the age of the annuitant at the date of the IRA owner’s death. Alternatively, a deferred gift annuity can delay the start of annuity benefits until the beneficiary is older.
Advantages of Making Charitable Contributions for Children

High net worth individuals who support charitable, religious or educational organizations often have adult children who also give to worthwhile causes. It might make sense for such parents to make charitable contributions on their children’s behalf, covering the kids’ annual gifts and possibly major gifts to capital campaigns. Several advantages should be available:

- Parents in high tax brackets may enjoy larger deduction tax savings than their children;
- Contributed amounts are removed from the parents’ estates and should not constitute taxable gifts unless they satisfy legally binding pledges of the children;
- Gifts can be planned so that the children receive gift recognition from the charity.

Would it ever make sense to reverse the process and have children make charitable contributions on behalf of parents? The idea would be for parents to give cash or securities to children, sheltered by the $14,000 per donee annual gift tax exclusion ($28,000 where couples split gifts). Gifts can be planned so that the children receive gift recognition from the charity.

Power of Attorney for Philanthropy

Many estate planning professionals view healthcare directives, especially the healthcare power of attorney, as a logical extension of estate planning that goes hand in hand with setting up a general durable power of attorney or naming a successor trustee to manage a client’s financial affairs in time of disability.

Consideration should also be given to future decision-making with respect to a person’s support for charitable organizations. Depending on the jurisdiction, the attorney in fact or successor trustee may have intrinsic power to carry on a disabled individual’s usual charitable giving patterns. But it may also be helpful to equip the attorney in fact or trustee with more extraordinary powers, such as:

- The ability to establish charitable remainder trusts or charitable gift annuities;
- The power to make major gifts to fund-raising campaigns;
- The ability to accelerate charitable bequests into inter vivos gifts that reduce current income taxes, particularly if it appears that the client may not have long to live.

charitable deduction ceilings (50% of AGI for cash gifts, 30% for appreciated assets such as securities) and can’t utilize carried-over deductions from past years;
- Parents are subject to the Pease limitation on certain itemized deductions, reducing their contribution deductions;
- Parents don’t have enough deductions to itemize but the children do.