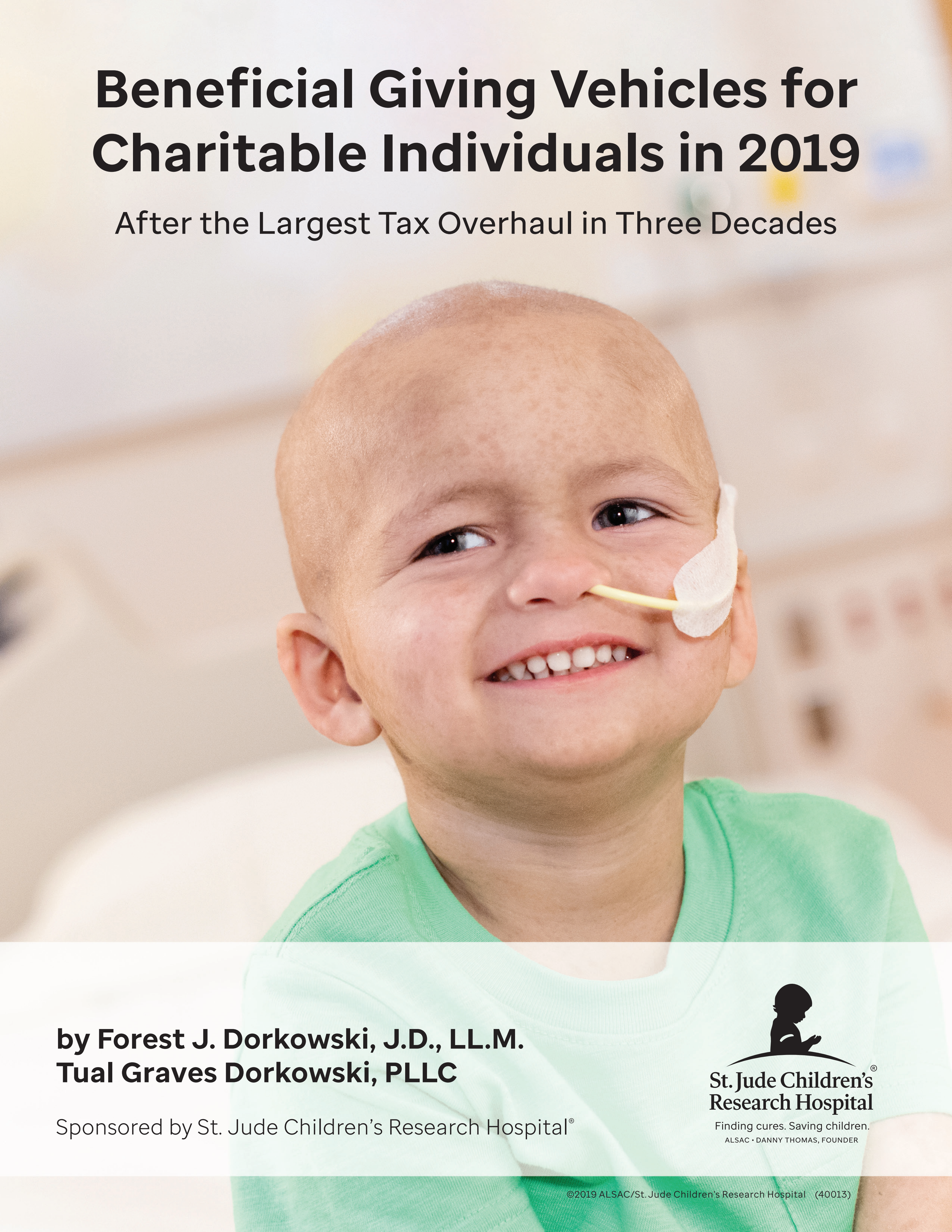
Beneficial Giving Vehicles for Charitable Individuals in 2019

After the Largest Tax Overhaul in Three Decades



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It has been over a year since the enactment of the Tax Cuts and Jobs Act of 2017 (the “Act”) and although it is still too soon to quantify its impact on charitable giving by individuals for 2018, we have enough data to advise our clients on the most tax advantageous ways to make charitable gifts this year.

It is the first quarter of 2019 and some individuals have already filed tax returns for 2018, although most have this still looming around the corner. Unfortunately, the IRS is slow to release tax return data and, as a result, analysis on tax return information, such as how many individuals continued to itemize deductions in 2018, will not be available for several years. This type of information is very important to understand how exactly the Act changed some of these very fundamental tax items for individuals; however, we still have a great deal of information we can rely upon to make predictions and assumptions for our clients. I am looking forward with much anticipation to June, when Giving USA will release its analysis on charitable giving for 2018. Predictions were scattered on how the Act would impact charitable giving, so stay tuned for updates with real numbers on charitable giving results from last year.

TO GIFT OR NOT TO GIFT IN LIGHT OF PROPOSED TREASURY REGULATIONS CONFIRMING NO CLAWBACK

In the estate and gift planning world, the new, very large federal estate tax exemptions created by the Act have stirred up much discussion among planners and their clients regarding whether or not large gifts should be made prior to the sunset of the exemptions at the end of 2025. Because the Act nearly doubled the federal estate and gift tax exemptions for individuals, our clients can now either gift during their lifetimes or leave to a non-spouse at their death $11.4 million in assets, and for our married clients, they can structure their estate plan to leave $22.8 million with no imposition of gift or estate taxes.[i]

Because the Act sunsets these estate and gift tax changes at the end of 2025, and because we cannot predict whether or not a client’s death will occur within this window, most estate planning considerations are still being made with the assumption that the exemptions will revert back to $5 million per person (indexed for inflation) beginning January 1, 2026. The potential reversion in the Act creates this window of time where individuals can make current gifts to take advantage of this excess exemption. Making a very large gift or series of gifts prior to the end of 2025 allows our clients to spread this gift out over several generations and absorb not only this additional estate tax exemption but also his or her generation-skipping transfer tax exemption. So long as these gifted assets remain in trust, they will never be included in a lower generation's estate for estate tax purposes.

The main concern with advising our clients to make such gifts has been the potential for the IRS to "claw" back the additional exemption at a client's death; however the Treasury Department has swiftly issued proposed regulations amending Treasury Regulation §20.2010-1, stating effectively that the IRS will not claw back any such gifts.[ii] The concern from tax practitioners and planners prior to these regulations was that a donor making a large gift during the increased exemption period (2018-2025) and then dying after the reversion back to the lower exemption would, upon computation of his estate tax, effectively be taxed on the large gift that was made even though it was made during a period where there was adequate available exemption to allocate to such gift. Because of the very technical nature of the estate tax computation whereby a decedent's prior taxable gifts are brought back into the estate and then the estate tax is calculated by applying the decedent's exemption, the concern was that, in a scenario where the exemption amount is lower at their death than it was when the large gift was made, this could effectively void the additional exemption originally allocated to the gift. Somewhat simply restated, the proposed rules provide that the larger exemption at the time of the gift can be used to absorb the gift when pulled back in the decedent's estate for estate tax purposes if the current exemption available at the decedent's death is not large enough. This is great news and adds needed clarity for many individuals who absolutely should consider making gifts to reduce their estates.

There are many ways for our clients to make these large gifts, including many split interest gifting options that provide for transfers to family members as well as charitable organizations. These gifting vehicles, including the charitable IRA rollover, the charitable gift annuity, charitable lead trusts (CLATS), charitable remainder trusts (CRATs and CRUTs), as well as many other gifting options, will be the focus of this year's series of articles, including advice on how to select the best instrument for your client, taking into consideration their specific charitable and non-charitable gifting goals as well as ever-changing economic factors.

The focus for the remainder of this article will be on two particular giving vehicles, the qualified charitable distribution a/k/a the Charitable IRA Rollover and the charitable gift annuity.

THE QUALIFIED CHARITABLE DISTRIBUTION A/K/A THE CHARITABLE IRA ROLLOVER

The Act left intact the Qualified Charitable Distribution (a/k/a charitable IRA rollover) which allows individuals over 70½ to make charitable gifts directly from an IRA (traditional or Roth) up to $100,000 each year to a qualifying charitable organization. The distribution can be used by individuals to satisfy part, or all, of that individual's required minimum distribution (RMD). This provision of the Code will allow those over 70½ who cannot itemize, due to the standard deduction increase and related changes, to make donations directly from their IRA to a charity, with the result being that any such distribution (up to $100,000) bypasses the individual's income for federal tax purposes.

Low income earners over 70½ who make donations each year, but not enough to justify itemizing their deductions, can now make charitable donations directly from their RMD, thus excluding that portion from being reported to them as income and still taking full advantage of the standard deduction to offset whatever other income they may have. In addition, by not having this RMD income included for income tax purposes, some individuals will avoid pushing their income up to levels that would otherwise cause a portion of their social security to be taxable. Many taxpayers who are over 70½ but who have very little income, surprisingly still pay income taxes. This is because although their incomes are low, many do not have mortgages and so do not have interest payments to combine with their charitable donations to push their deductions over the standard deduction levels in order to itemize; however, many still make charitable donations. Before the Charitable IRA Rollover, these individuals were not able to receive any tax benefit from their donations, but now many will see a reduction in taxes simply by making the donation they would have made anyway directly from their RMDs.

For taxpayers over 70½ who itemize already and who will continue to itemize, this provision allows them to, in effect, take a 100% charitable deduction. Because the RMD income that pays directly to a qualifying charity is not included in the donor's adjusted gross income it is also not subject to any limitations that would otherwise apply to charitable donations, such as the alternative minimum tax. Those of our clients who are very wealthy and who want to make large charitable gifts can donate up to $100,000 to a qualifying charity from their IRA, avoiding having to pay current income taxes on that amount while preserving their non-retirement assets for their family members to inherit at their deaths. Gifting retirement assets in this manner to charity during a donor's lifetime can help ensure that more of the donor's other non-taxable assets are left for their family members at their death. Beneficiaries will always be better off receiving non-retirement assets, as they will receive a stepped up cost basis for all other assets (eliminating capital gains taxes in many cases when sold soon after the decedent's death) and will not have to include the proceeds from any inherited IRA in their income for income tax purposes. Because a charitable organization will not pay taxes on the IRA income received, this scenario leaves more money in the hands of charities and family members in a situation where the donor desires to leave assets to both.

In order to take advantage of the Charitable IRA Rollover, individuals over 70½ must fill out the appropriate paperwork with their IRA custodian to allow their required minimum distributions and even larger amounts up to $100,000 to be paid directly from their IRA to a qualifying charitable organization. Donors need to have this process completed by year end to ensure receiving credit for their required minimum distribution prior to the December 31st deadline. All potential donors need to be made aware of this option as it benefits taxpayers at *all* income levels and is available to and benefits *both itemizers and non-itemizers*, as the income distributed to the charitable organizations completely bypasses the individual's taxable income. Remember to advise donors that donor advised funds and supporting organizations are *not* qualifying recipients of these rollovers.

CHARITABLE GIFT ANNUITIES

The charitable gift annuity, or CGA, is a contract directly between an individual and a charitable organization in which the individual transfers cash or appreciated assets to the charity in exchange for a stream of payments that continue for the donor's lifetime. CGAs are not for every client, however there are many who are uniquely suited to the benefits that a CGA can offer. What are the benefits and downsides of purchasing a CGA and who should consider this type of gift?

- The payout or annuity for a CGA is determined at the inception of the contract and does not fluctuate, regardless of market conditions. Additionally, a CGA is backed by the issuing organization's entire balance sheet so, in contrast to a donor funding a charitable remainder trust, the return and obligation to make payments is not limited solely to the investment performance of the funds used to purchase the CGA. Clients who desire a guaranteed stream of income can choose a charity they trust with a strong balance sheet and will have virtually no risk of losing their promised annuity. Most states have their own requirements that an organization be registered and/or licensed in order to issue a CGA and some require the organization to maintain investment reserves, so planners are encouraged to consider these additional safeguards when advising clients.[iii]

- The annuity will continue for the lifetime of the annuitant (usually this is the individual who purchases the annuity) or for the joint lifetimes of two annuitants (usually a married couple). Although the payout rate is determined at inception and based on several factors, the annuitant is guaranteed their annuity payment regardless of whether or not they outlive the life expectancy upon which their payout was based. Donors can choose to purchase CGAs that provide for immediate payouts or can structure them so that payment begins sometime in the future, known as the deferred CGA. The payout rate for a CGA will necessarily be lower than an annuity purchased on the private insurance market to take into account the charitable gift.

- The annuitant will be allowed a charitable contribution tax deduction (subject to limitations that would otherwise apply to such taxpayer's ability to claim such a deduction) for the year in which they purchase the CGA. The amount allowable as a deduction will equal the present value of the remainder portion that will ultimately go to the charity, which value is determined using mortality tables sanctioned by the IRS for valuing such interests and current interest rates.

    Ex: A donor, age 55, purchased a CGA from ALSAC/St. Jude in December of 2018 in the amount of $50,000 with cash. The Donor will receive an immediate charitable contribution deduction for $15,829 and be entitled to an annual payout of $2,150, of which $1,200 will be tax free income for the first 28.5 years.[iv]

  Although the precise calculations are complex, the gift planning department at your client's favorite charity will be able to provide those for you with ease. Keep in mind when advising clients that a CGA can be purchased for someone else as a gift. Consider the same payout and deduction in the above example but instead the donor/purchaser receiving the deduction purchases the CGA for a sibling, a significant other or an adult child, naming them as the annuitant. In this scenario, the present value of the gift to the annuitant would have to be considered but with the current annual exclusion of $15,000 per donee and the $11.4 million lifetime gift tax exemption, taxable gifts are a thing of the past for most donors.

- A portion of the annuity payment will be income tax free, as such portion will be treated as part of the initial after-tax investment made by the taxpayer to purchase the annuity. For cash only purchases, the portion of each annuity which will be taxable represents the expected earnings on that initial investment, spread out over the annuitant's life expectancy. Once the annuitant has lived beyond their life expectancy (as determined as of the inception of the CGA contract) the annuity payments received after such time will all be treated and taxed as ordinary income.

- If appreciated property, such as stock, was used to purchase the CGA, the capital gain that would have otherwise been triggered by the taxpayer if they had first sold the stock and then donated the proceeds will be reduced as well as the balance spread out and taxed over the annuitant's life expectancy. This installment sale treatment of the annuitant's capital gain is only available if the donor/purchaser is at least one of the annuitants and if the annuity is only assignable to the issuing organization.

Consider a donor, age 70, who has property valued at $150,000 with a cost basis of $75,000. This donor is unmarried and has no children, and desires to sell this piece of property. If the donor sold the property before donating the proceeds, they would have to realize a capital gain of $75,000 which gain could be taxed as high as 23.8% at the federal level. If the donor instead transferred the property to a charity in exchange for a CGA with a payout rate of 5.6%, they would receive the following benefits:

- A charitable contribution deduction in the amount of $61,613 for the year of the transfer/purchase

- An annual payout of $8,400 for the remainder of the donor's lifetime

- For the first 15.9 years (donor's life expectancy) $2,780 of the payout each year would be tax free to the donor, with same amount being treated as capital gain income and $2,839 being treated as ordinary income

- The transfer to the CGA reduced the donor's realized capital gain from $75,000 to $44,194, meaning that only the smaller amount is ever actually reported and taxed to the donor as capital gain

If this same donor had instead used all cash to purchase the CGA, he would have received $5,561 of each annual payment income tax free for the first 15.9 years, after which the entire $8,400 annuity payment would be included in his gross income for tax purposes.

Planners should always consider charitable gift annuities as an option for their clients, as this type of charitable split interest gifting vehicle can benefit taxpayers of all ages and at all levels of wealth.

CONCLUSION

After passage of the Tax Cuts and Jobs Act of 2017 most of our clients have no concerns about making taxable gifts or having a taxable estate at their death. For many of our wealthier clients this means they will be left with more assets to leave at death or gift during their lifetime to family members as well as more they can donate to charitable organizations. As planners, we need to shift our focus from avoiding estate taxes to assisting our clients with ways to reduce and/or eliminate income taxes, including capital gains taxes, by structuring lifetime gifts that include charitable donations. I have discussed two possible techniques in this article and will cover other split gifting techniques and other gifting options, both charitable and non-charitable, in future articles this year. Now that we are certain that any gifts made will not be "clawed" back by the IRS at a client's death, we can advise our clients with certainty and truly provide tax savings both to them and future generations.

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[i] The IRS released the inflation adjusted estate, gift and generation-skipping transfer tax exemptions in November of 2018 and have increased each from $11.18 million per taxpayer to $11.4 million per taxpayer.

[ii] Federal Register/Vol. 83, No. 226/Friday, November 23, 2018/Proposed Rules

[iii] The American Council on Gift Annuities (ACGA) provides a list summarizing the individual state requirements at https://www.acga-web.org/state-regulations

[iv] This particular calculation provided by ALSAC/St. Jude Gift Planning Department using the applicable IRS discount rate in December of 2018 and using the payout rate provided in the ACGA 2018 table.