Charitable Giving in a Low Interest Rate Environment

A White Paper by Manning & Napier
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Introduction
There are numerous types of charitable giving vehicles available to those who have a desire to make substantial gifts to charity. If used effectively, charitable giving can be an important component of a strategic financial plan that benefits both the donor and the charity. To do so, individuals must recognize their current/future financial liabilities, compare the pros and cons of each vehicle relative to their ultimate goals, and assess their efficiency given the present market conditions.

Split-Interest Trusts
While the ultimate goal of charitable giving is to benefit the charity, if certain types of vehicles are used, the donor may receive benefits as well. These vehicles are known as split-interest charitable trusts. In a split-interest trust, the assets gifted by the donor are split into two parts: a stream of income produced by the asset and the principal remaining after the income interest is paid. Here, depending on the type of trust that is established, the donor or the named beneficiaries either receive the income interest each year or the remainder interest at the completion of the trust, while the charity receives the other interest. Furthermore, when using a split-interest trust, the donor must look at the pros and cons of the various charitable giving vehicles and determine which one is the best fit for their goals. For example, is the donor's ultimate goal to gain an income stream from the charitable gift? Or is their ultimate goal to pass along wealth to their heirs? Depending on the answers to these questions, the donor may choose between a charitable remainder trust, which provides them with an income stream each year from the income interest, and a charitable lead trust, which allows the donor to transfer wealth to their heirs from the remainder interest.

Split-Interest Charitable Vehicles
Charitable Remainder Annuity Trust (CRAT)
What is it: A charitable remainder annuity trust is an irrevocable trust in which a donor transfers assets to a trustee. Over a period of time, not exceeding the longer of 20 years or the donor's life expectancy, the donor or designated beneficiaries receive an annual fixed payment determined upon the trust's inception. Once the specified period of time has passed, the remainder of the principal goes to one or more charities.

Advantages:
• Donor or designated beneficiaries receive a fixed income for a number of years
• Immediate recognition of capital gains taxes are avoided on long term appreciated assets that are donated
• Reduces donor's estate which ultimately reduces estate taxes paid
• Donor receives an income tax deduction for a portion of his/her donation
• Donor is able to change which charity the trust ultimately benefits
• Satisfies charitable giving desires

Disadvantages:
• Loss of control over assets
• Payments remain constant regardless of changes in the value of the trust
• Cannot keep pace with inflation
• Fees associated with establishment of trust and administrative fees
• Heirs do not have access to assets

Typical Donor Profile:
• Between the ages of 55 and 80
• Plans on making one large gift (it is generally recommended that the gift be over $100,000)
• Wants a fixed income for either life or a specified number of years
• Has appreciated securities or assets that produce little income

Effect of Market Conditions: Since the payment is fixed, the income received by the donor or designated beneficiaries is not impacted by market conditions; however, the principal ultimately received by the charity may be affected. If the trust has a high payout rate and interest rates are low, it is possible for the trust to be depleted, leaving no funds for charity. Generally speaking, in high interest rate environments, CRATs offer the donor a larger tax deduction than other charitable vehicles.

Charitable Remainder Unitrust (CRUT)
What is it: A charitable remainder unitrust is identical to a CRAT except for the payout ratio. Unlike a CRAT, the income received by the donor or designated beneficiaries is defined as a percentage of the market value of the trust and therefore can vary each year. Here, the donor or designated beneficiaries receive a fixed percentage of no less than 5% of the principal of the trust that is revalued annually.
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Advantages:
- Donor or designated beneficiaries receive an income stream for a number of years
- Income received can be larger each year if investment returns are favorable
- Immediate recognition of capital gains taxes are avoided on long term appreciated assets that are donated
- Reduces donor’s estate which ultimately reduces estate taxes paid
- Donor receives an income tax deduction for a portion of his/her donation
- Satisfies charitable giving desires
- Donor is able to change which charity the trust ultimately benefits
- Potential for distribution to keep pace with inflation

Disadvantages:
- Loss of control over assets
- Income received can be smaller each year if investment returns are unfavorable
- Fees associated with establishment of trust and administrative fees
- Heirs do not have access to assets

Typical Donor Profile:
- Between the ages of 55 and 80
- May potentially make future gifts
- Wants a stream of income over a number of years that has the potential to increase in value
- Has appreciated securities or assets that produce little income

Effect of Market Conditions: Since payment is a fixed percentage of the principal of the trust that is revalued each year, the donor or designated beneficiaries may receive either a larger or smaller payout amount from year to year depending on market performance. In general, in low interest rate environments, CRUTs offer the donor a larger tax deduction than CRATs.

Charitable Lead Annuity Trust (CLAT)
What is it: A charitable lead annuity trust is essentially the reverse of a charitable remainder annuity trust. Rather than paying the donor or designated beneficiaries a fixed amount each year, a CLAT initially pays the charity a fixed amount each year. Once the specified period of time passes, the remaining assets are passed to the donor’s non-charitable beneficiaries.

Advantages:
- Removes assets from donor’s estate allowing for potential estate and gift tax savings
- Satisfies charitable giving desires
- Allows for the passing of wealth to heirs
- Donor is able to change which charity the trust ultimately benefits

Disadvantages:
- No income tax deduction***
- Loss of control over assets
- Payout to charity cannot keep pace with inflation
- Fees associated with establishment of trust and administrative fees

Typical Donor Profile:
- Has assets that are expected to grow over the life of the trust
- Wants to pass on wealth to heirs
- Does not require an income stream from the assets each year

Effect of Market Conditions: CLATs are ideal for today’s low interest rate environment. With the IRS 7520 rate at historically low levels, if the growth of the assets exceeds the 7520 rate, the greater the amount of funds that can be passed along to a donor’s heirs without incurring estate/gift taxes.

Charitable Lead Unitrust (CLUT)
What is it: A charitable lead unitrust is identical to a CLAT except for the payout ratio. Like a CRUT, payments are determined by a fixed percentage of the principal value of the trust that is revalued each year.

Advantages:
- Removes assets from donor’s estate allowing for potential estate and gift tax savings
- Satisfies charitable giving desires
- Allows for the passing of wealth to heirs
- Donor is able to change which charity the trust ultimately benefits

Disadvantages:
- No income tax deduction***
- Loss of control over assets
- Fees associated with establishment of trust and administrative fees
Typical Donor Profile:
- Has assets that are expected to grow over the life of the trust
- May potentially make future gifts
- Wants to pass on wealth to heirs
- Does not require an income stream from the assets each year

Effect of Market Conditions: Similar to CRUTs, CLUTs pay a fixed percentage of the principal of the trust which is revalued each year. Unlike the CRUTs where the donor receives the income, in a CLUT the charity may receive either a larger or smaller payout amount from year to year depending on market performance. In high interest rate environments, CLUTs generally provide the donor with a greater charitable gift tax credit than CLATs.

*** Please note: Lead trusts can either be grantor or non-grantor trusts. In a grantor trust, the donor may claim an immediate income tax deduction, but has to list any income generated by the trust in their income tax each year. In a non-grantor trust, which is described above, the donor may not claim an immediate income tax deduction; however, they will not have to include any income generated by the assets in the trust in their annual income tax.

Pooled Income Fund (PIF)
What is it: A pooled income fund is an irrevocable trust that is run by a charity. Based on the value of the assets transferred to the fund, the donor receives a shared interest of the fund and receives income proportional to their interest. Upon the death of the donor or designated beneficiaries, the charity receives the donor’s portion of the principal.

Advantages:
- Donor can avoid capital gains tax on appreciated assets that are donated to the fund
- Removes assets from donor’s taxable estate
- Gives the donor a current income tax deduction
- Provides donor with a stream of income each year
- No establishment or administrative fees
- Satisfies charitable giving desires
- Income received may increase based on favorable market fluctuations
- Donor is able to make multiple gifts

Disadvantages:
- Donor is not able to change the charity
- Loss of control of assets
- Heirs do not have access to assets
- Income received may decrease based on unfavorable market fluctuations

Typical Donor Profile:
- Has many appreciated securities or assets that produce little income
- Can tolerate market fluctuations

Effect of Market Conditions: Similar to a mutual fund, a PIF is subject to market fluctuations. If the market and/or fund is performing well, the donor will receive an increased income payment that year. On the other hand, if the fund is not performing well, the donor will receive a smaller income payment.

Impacts of Low Interest Rates on Split-Interest Vehicles
The Federal Reserve has signaled that it plans to maintain its current low interest rate approach until at least 2015. Keeping this in mind, donors looking to make split-interest charitable gifts should look at the ways in which low interest rates impact the different types of charitable giving vehicles. For example, CLATs offer advantages in a low interest rate environment. The lower the Charitable Federal Midterm Rate (CFMR), the greater the present value of the income interest and thus the lower the present value of the remainder interest. Simply put, the lower the CFMR, the greater the gift tax credit and the greater the chance that the trust will generate returns in excess of the CFMR, allowing the transfer of additional wealth to noncharitable beneficiaries upon completion of the trust estate/gift tax free.

On the other hand, while low interest rates have a positive impact on CLATs, they have the opposite effect on CRATs. Here, since the donor receives the income interest as opposed to the remainder interest, he or she receives a lower income tax deduction as it is assumed that the charity will be receiving less money. Furthermore, in a low interest rate environment, it is more difficult for CRATs to pass the 5% probability test, which states that a gift may not qualify for a deduction if there is greater than a 5% probability that the trust will exhaust its assets before the charity receives the remainder interest.
Although charitable lead trusts are more favorable than charitable remainder trusts in a low interest rate environment, they may not align with the donor's overall goals. As a result, donors must then look at the ways interest rates impact annuity trusts vs. unitrusts. For example, if the donor's intention is to pass wealth along to heirs, he or she would choose a charitable lead trust. In today's interest rate environment, the donor would receive a greater gift tax credit by choosing a CLAT. If the donor's intention is to receive an income stream from the assets each year, he or she would choose a charitable remainder trust. In a low interest rate environment, the donor would receive a larger income tax deduction by choosing to use a CRUT.

Examples in Varying Interest Rate Environments

**Example 1:** Mr. Jones has an estate valued at $3 million. While he would like to make a donation to charity, Mr. Jones is looking to receive an income stream each year from his assets. To satisfy his charitable giving desires and financial needs, he decides to gift $2 million dollars worth of appreciated assets to a charitable remainder trust for 20 years with an initial payout of $100,000. Holding these variables constant, below are examples of the benefits Mr. Jones will receive from a charitable remainder annuity trust and unitrust in both high and low interest rate environments.

**High Interest Rate Environment**

**Charitable Remainder Annuity Trust:** Using a CRAT, when the IRS discount rate is 7.6%, Mr. Jones will receive an income tax deduction of $959,820. In addition to the initial income tax deduction, he will receive $100,000 income annually from the trust. At the trust's completion, the charity of his choice will receive the remainder interest.

**Charitable Remainder Unitrust:** Using a CRUT, when the IRS discount rate is 7.6%, Mr. Jones will receive an income tax deduction of $751,360. In addition to the initial income tax deduction, he will receive $100,000 income for the first year; however, future income received will be determined each year based on the trust's value. At the trust's completion, the charity of his choice will receive the remainder interest.

**Low Interest Rate Environment**

**Charitable Remainder Annuity Trust:** Using a CRAT, when the IRS discount rate is 1.2%, Mr. Jones will receive an income tax deduction of $223,320. In addition to the initial income tax deduction, he will receive $100,000 income annually from the trust. At the trust's completion, the charity of his choice will receive the remainder interest.

**Charitable Remainder Unitrust:** Using a CRUT, when the IRS discount rate is 1.2%, Mr. Jones will receive an income tax deduction of $722,600. In addition to the initial income tax deduction, he will receive $100,000 income for the first year; however, future income received will be determined each year based on the trust's value. At the trust's completion, the charity of his choice will receive the remainder interest.

Figure 1

**Figure 1**

Figure 1 assumes a gift of $2 million with an initial payout of $100,000 over a 20 year period

**Brief Analysis:** As the interest rate rises, the deduction increases. CRUTs offer donors greater tax deductions than CRATs in low interest rate environments. Once the interest rate becomes greater than approximately 5.1%, CRATs offer donors greater tax deductions than CRUTs.
Example 2: Mr. Smith has an estate valued at $3 million and has three children. He is looking to make a donation to charity during his lifetime, while ensuring that his heirs will receive his wealth after his passing. To satisfy his charitable giving desires and estate planning goals, he decides to gift $2 million dollars worth of assets that he expects to appreciate over time to a non-grantor charitable lead trust for 20 years with an initial payout of $100,000. Holding these variables constant, below are examples of the benefits Mr. Smith will receive from a CLAT and a CLUT in both high and low interest rate environments.

High Interest Rate Environment

Charitable Lead Annuity Trust: Using a non-grantor CLAT, when the IRS discount rate is 7.6%, Mr. Smith will not receive an income tax deduction for his donation; however, he will receive a gift tax credit for $1,040,180 (the amount deemed to be going to charity). As a result, his total taxable gift will be $959,820, which can be further reduced by using his lifetime gift and estate tax exclusions. Throughout the trust's life, the charity of Mr. Smith's choice will receive $100,000 income annually. After the specified term of years, Mr. Smith's beneficiaries will receive the remainder interest, including any appreciation that occurs over the trust's life without incurring estate/gift taxes.

Charitable Lead Unitrust: Using a non-grantor CLUT, when the IRS discount rate is 7.6%, Mr. Smith will not receive an income tax deduction for his donation; however, he will receive a gift tax credit for $1,248,640. As a result, his total taxable gift will be $751,360. In addition, the charity of Mr. Smith's choice will receive $100,000 income for the year the trust was created; however, future income received will be determined each year based on the trust's value. After the specified term of years, Mr. Smith's beneficiaries will receive the remainder interest, including any appreciation that occurs over the trust's life without incurring estate/gift taxes.

Low Interest Rate Environment

Charitable Lead Annuity Trust: Using a non-grantor CLAT, when the IRS discount rate is 1.2%, Mr. Smith will not receive an income tax deduction for his donation; however, he will receive a gift tax credit for $1,248,640. As a result, his total taxable gift will be $751,360. In addition, the charity of Mr. Smith's choice will receive $100,000 income for the year the trust was created; however, future income received will be determined each year based on the trust's value. After the specified term of years, Mr. Smith's beneficiaries will receive the remainder interest, including any appreciation that occurs over the trust's life without incurring estate/gift taxes.

Charitable Lead Unitrust: Using a non-grantor CLUT, when the IRS discount rate is 1.2%, Mr. Smith will not receive an income tax deduction for his donation; however, he will receive a gift tax credit for $1,277,400. As a result, his total taxable gift will be $722,600. In addition, the charity of Mr. Smith's choice will receive $100,000 income for the year the trust was created; however, future income received will be determined each year based on the trust's value. After the specified term of years, Mr. Smith's beneficiaries will receive the remainder interest, including any appreciation that occurs over the trust's life without incurring estate/gift taxes.

Figure 2

Brief Analysis: As the interest rate rises, the gift tax credit decreases. CLATs offer donors greater gift tax credits than CLUTs in lower interest rate environments. Once the interest rate becomes greater than approximately 5.1%, CLUTs offer donors greater gift tax credits than CLATs.
APPENDIX

Additional Charitable Vehicles

**Donor Advised Fund**

**What is it:** A donor advised fund is a separately identified fund or account that is maintained and operated by a public charity. In a donor advised fund, the donor plays an advisory role in the distribution of the funds they have donated, i.e suggesting which charities receive funds and the amount each charity receives.

**Advantages:**
- Donor can avoid capital gains tax on appreciated assets that are donated to the fund
- Removes assets from donor’s taxable estate
- Gives the donor a current income tax deduction
- Satisfies charitable giving desires
- Gives donor a say in which charities benefit from the fund
- Allows donor to make multiple gifts
- Allows for donor anonymity
- No set up costs

**Disadvantages:**
- Does not provide donor with annual income payments

**Typical Donor Profile**
- Has appreciated securities or assets that produce little income
- Does not require a stream of income from the assets each year
- May potentially make future gifts; however, these gifts generally will be smaller than the initial gift

**Effect of Market Conditions:** Unlike other charitable giving vehicles, market conditions do not have an impact on the donor, as the donor does not receive any type of annual income from the fund.

**Private Foundation**

**What is it:** A private foundation is a non-governmental, non-profit organization which is generally created by donations from an individual, family, or corporation and whose programs are managed by its own trustees or directors.

**Advantages:**
- Donor can avoid capital gains tax on appreciated assets that are donated to the fund
- Removes assets from donor’s taxable estate
- Gives the donor a current income tax deduction
- Satisfies charitable giving desires
- Gives donor complete control over which charities receive funds and the amount they receive
- Helps create a family legacy for future generation

**Disadvantages:**
- Does not provide donor with annual income payments
- Strict operating rules
- High establishment cost and administrative fees
- Must distribute 5% of fair market value of assets annually
- Does not allow for donor anonymity

**Typical Donor Profile:**
- Plans on making only one large gift (generally over $1 million)
- Has appreciated securities or assets that produce little income
- Does not require an income stream from the assets each year

**Effect of Market Conditions:** Although the donor does not receive any type of annual income from the foundation, if the funds are not performing well, the donor still has to pay administrative fees for the foundation and must distribute 5% of the fair market value of the assets annually.
Key Concepts

**Estate Tax:** Tax imposed by federal government on the transfer of property from one person to another at death. Estate tax may also be charged at the state level.

**Gift Tax:** Tax imposed by federal government on the transfer of property from one person to another during lifetime.

**Generation Skipping Transfer Tax (GSTT):** Tax imposed by federal government on transfer of property either through gift or inheritance to a beneficiary more than 37.5 years younger than the donor if unrelated and more than one generation younger than the donor if related.

**Taxable estate:** Gross estate less allowable deductions

**Itemized deduction:** A deduction from the taxpayer’s taxable adjusted gross income made up of deductions for money spent on certain goods and services throughout the year. The specific deductions that may be itemized are outlined by the IRS.

**Adjusted Gross Income (AGI):** Gross income minus allowable deductions.

**Section 7520 Rate/Charitable Federal Midterm Rate (CFMR):** Percentage rate published by the Treasury that is used to calculate the present value of annuities, interest for life or for a term of years, and remainder or revisionary interests to determine income, estate, and gift tax charitable deductions. It is calculated by multiplying the monthly Applicable Federal Midterm Rate by 120 percent and rounding the product to the nearest two-tenths of one percent.

**Limits on Charitable Deductions (IRS Publication 526):** The amount of your deduction for charitable contributions is limited to 50% of your AGI, and may be limited to 30% or 20% of your AGI, depending on the type of property you give and the type of organization you give it to. If your charitable contribution is greater than 50% of your AGI, the excess of limits can be carried over for up to five years after the year of gift.

**Types of Charities:** 50% charities are generally churches, schools, hospitals, and government entities. 30% charities are typically private foundations.

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**50% Limit:** The 50% limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your AGI for the year. The 50% limit is the only limit that applies to gifts to organizations listed under 50% Limit Organizations. However, there is one exception. A special 30% limit also applies to these gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation.

**30% Limit:** The 30% limit applies to gifts to all qualified organizations other than 50% limit organizations. Similar to the 50% limit, if gifts are of long-term capital gain property for which you figure your deduction using fair market value without reduction for appreciation, the deductible may only be up to 20% of AGI.