The Tax Man (Surely Will) Cometh: Modeling before-tax and after-tax consequences of life income gift arrangements

When preparing illustrations for prospects interested in establishing life income charitable gift arrangements, projections of future benefits can complicate modeling income projections. From a tax perspective, categorization of income from gift annuities and charitable remainder trusts depends on a number of factors. Some of the income may be reported as ordinary income, to be taxed at the donor's highest marginal income tax bracket, while some of the income may be reported as realized capital gains and taxed at a much lower rate. A portion of the income may even be considered to be return of principal, which is by definition tax-free. The gift-planning professional may find it helpful to illustrate the consequences of the gift arrangement from both the before-tax and after-tax perspectives. Doing so may help the donor understand the potential benefits of a complex charitable gift arrangement. Let's review how that works.

Commented [GP1]: Don't know if you meant the profession, but I think it's a little awkward.

PG Calc's *Planned Giving Manager* (*PGM*) offers the user a wide range of flexibility and sophistication in the area of anticipating tax consequences and their effects. This functionality is also an integral feature in our new website gift modeling services as the examples on the web pages typically show the donors' tax savings. *PGM*, (in Program 3 – Life Income Projections) allows the demonstration of the tax effects on both the original income tax deduction and on the future projected income anticipated over the life expectancy of the donors (or projected years for a term-of-years trust). Of course, introducing the ability to incorporate the tax consequences for a particular donor with a particular gift arrangement presents a whole new set of questions that may seem overwhelming at first blush. What is the donor's tax bracket? Will it change in the coming years as the donor transitions into retirement? *And how do you model the tax consequences if you don't know the donor's tax bracket and don't feel comfortable asking?*

One thing to keep in mind is that projections of life income gift arrangements are just that- *projections* – they are estimates of anticipated future results, so we know we are already dealing with a certain degree of conjecture. We can only make educated guesses about future investment results, based on our current assumptions, and the amount of tax on the resulting income will be subject to the reliability of the investment assumptions. Furthermore, tax brackets are bewildering to all but the most highly skilled accountants, because it's difficult to anticipate when income will exceed one bracket and flow into the next bracket. But it is still worthwhile to make a reasonable attempt to illustrate the general effects of taxation, remembering to emphasize the difference to the donor between a projection and a guarantee.

Back to our questions – has the donor given us an idea already about his or her tax bracket? What we mean specifically is the *marginal income tax bracket* – what will the rate of taxation be on any *new income the donor receives in the future* from a life income gift arrangement? Keep in mind that in some cases the donor's marginal income tax bracket could change over time because of winding down a professional career. Also in some cases the donor is not the beneficiary, and the two might have significantly different levels of tax burden. If the donor hasn't provided any idea of the level of taxation, you could simply stick with PGM's default choices – 39.6% for taxable income and 20% for realized long-term capital gains. Those are currently the highest federal income tax brackets in the U.S. tax code. For those individuals, the final rate is actually higher as we typically anticipate the additional 3.8% net investment income tax that is frequently referred to as the "Medicare Surtax." When presenting numerical examples on your web page, does it make sense to use the highest rates or should you use rates more in the middle of the income range? Our web-based GiftCalcs tool allows this choice, but there is no set rule to determine the optimum rate to use in a given situation-.

Commented [GP2]: Was there a whole blog on this subject, and if so can that be referenced?

(BTR) I linked it

The rates shown above are only the highest numbers for the federal income and capital gains taxes. What about state income taxes? Most states have an income tax, and as a rule, realized capital gains are taxed as well. *PGM* doesn't include any default for state taxes because our clients represent all 50 states and the District of Columbia. It would be impossible to settle on anything for a default that wouldn't confuse or upset a significant percentage of our users. If the gift planner knows the state the donor resides in, and is familiar with that state's income tax rate schedule, it is perfectly appropriate to use an assumed percentage for state taxes. One of the more clever features in *PGM* is that it *blends the two tax rates mathematically into a realistic hybrid rate because of the usual deductibility of state taxes on the federal levy* – so a 35% federal tax rate and a 7% state tax rate are combined into a *blended rate of 39.55%,* rather than an overly simplistic 42% rate that wouldn't actually occur in the real world. Regardless of the rates used to create a projection, the income tax and capital gain tax assumptions in each PGM projection are displayed on each page of the output from Program 3 – Life Income Projections.

If your donor hasn't provided much information about his or her tax brackets, and you can't - or don't wish to - inquire specifically about that information, you may wish to use something other than the standard default rates in *PGM*. If you click on one of the white spaces in the Income / Cap Gains Tax Rates input screen, then click on the question mark at the top of the screen, a context-specific portion of the Help system appears, providing some generally useful information about the taxation features in *PGM*; it *also provides direct links to the current federal tax bracket tables* – one for single taxpayers, one for married filing jointly taxpayers, and so on. For example, you could see that a married couple filing a joint income tax return would not be at the top bracket of 39.6% unless their income exceeded $457,600. It might make more sense to assume a 33% percent marginal bracket, which would apply to couples whose income exceeds $226,850 but is not greater than $405,100. Here is what that portion of the Help section looks like:

Schedule Y-1: Married Filing Jointly and Surviving Spouses

Example: Joe and Diane Johnson have a combined income of $130,000 in 2014. They have two dependent children and allowable itemized deductions (consisting solely of medical expense deductions) of $12,000. They file a joint return. Their taxable income is $102,200: $130,000 - $12,000 itemized deductions - $15,800 for four personal exemptions. Their tax is $17,262.50: $10,162.50 + .25 x ($102,200 - $73,800).

2014

Taxable Income*	Tax	% on Excess
$0	$0	10
18,150	1,815	15
73,800	10,162.50	25
148,850	28,925	28
226,850	50,765	33
405,100	109,587.50	35
457,600	127,962.50	39.6

Source: Revenue Procedure 2013-35

The advantage of using these advanced features is that the resulting illustrations can offer donors a much more comprehensive picture of the projected long-term benefits from a gift arrangement. Your donor can see the effect of the anticipated tax on the income from the arrangement. If you choose to compare multiple gift plans, you can illustrate how the relative value of one plan versus another can be greatly affected by the degree of taxation likely to occur. A perfect example is the comparison between a charitable gift annuity and a charitable remainder trust – one vehicle may appear to be a better choice for the donor when looking at the before-tax numbers, but the other vehicle may appear more beneficial when factoring in the amount of tax burden. *There is no right or wrong choice*, it's simply what makes more sense to this particular donor given the current circumstances.

In the end, modeling gift plans that show both before- and after-tax income increases the gift planner's ability to help donors achieve their ultimate objective: creating a life income gift arrangement that yields the maximum income over time for the donor and the maximum benefit for the organization in the end. There will always be taxes and they will always affect the true value of the income received from these gift arrangements. It's only logical to provide the donor with the most information so that he or she can make the best-informed decision. Then everyone wins.

We hope that this article has been helpful. If you have any questions about the content, or would like to discuss the subject of what rates to use for PGM and your website and how to present them further, please feel free to call us at 1-888-474-2252 or email us at support@pgcalc.com.

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