



# Hey, What's Up?

PG Calc Featured Article, May 2018

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I'll tell you what's up. The IRS discount rate, the interest rate used in computing the deduction for gift annuities, charitable remainder trusts, retained life estates, and charitable lead trusts. It's edged upward a full percent in the last 6 months, and it appears likely to continue that trend for the rest of 2018 as the Federal Reserve continues to gradually raise interest rates.

As of April, the IRS discount rate is 3.2%. While 3.2% is still a historically low rate, it's the highest it's been in seven years. Should it reach 4.0% by the end of the year, it would be the highest it has been in ten years. How has this movement affected the benefits of making a planned gift?

## Gift Annuities

Eighteen months ago, the IRS discount rate was 1.4%, less than half of what it is now. As the table below shows, an upward movement in the IRS discount rate has two opposing effects on the benefits of funding a gift annuity. On the one hand, the charitable deduction increases. On the other hand, the tax-free portion of the annuity decreases by the same proportion.

### Gift Annuity funded with \$25,000 cash for a 75-year-old

	1.4% IRS Discount Rate	3.0% IRS Discount rate	4.0% IRS Discount rate
<b>Charitable deduction</b>	\$10,465	\$11,977	\$12,791
<b>Annuity</b>			
<b>Tax-free portion</b>	\$1,172	\$1,050	\$985
<b>Ordinary income</b>	\$278	\$400	\$465

For a donor who itemizes her deductions, the improved deduction should make funding a gift annuity more attractive. However, under the new tax law many more donors will be taking the standard deduction rather than itemizing. For these donors, the increased deduction will be of no value, and the greater taxation of their annuity payments will reduce the value of these payments net of taxes. Regardless of the trend in IRS discount rates, a gift annuity donor who does not itemize should choose the lowest of the three IRS discount rates available in the month of her gift in order to maximize the tax-free portion of her annuity payments.

The impact of a rising IRS discount rate depends on the number of annuitants and their ages. The longer the annuity is likely to last, the greater the effect. So, the effect is greatest when there are two annuitants and they are both relatively young. For example, the deduction for a gift annuity with two 70 year-old annuitants has increased over 40% in the last 18 months (see the table below). Compare that to the 14% increase in the deduction for a gift annuity with one 75 year-old annuitant during the same time period. Of course, the flip side is that the tax-free portion of their annuity for two 70 year-olds has decreased over 40%.

### **Gift Annuity funded with \$25,000 cash for two 70 year-olds**

	<b>1.4% IRS Discount Rate</b>	<b>3.0% IRS Discount rate</b>	<b>4.0% IRS Discount rate</b>
<b>Charitable deduction</b>	\$6,370	\$8,974	\$10,317
<b>Annuity</b>			
<b>Tax-free portion</b>	\$908	\$782	\$716
<b>Ordinary income</b>	\$242	\$368	\$434

### **Charitable Remainder Trusts**

The effect of a rising IRS discount rate on a charitable remainder trust depends on the type of trust. The effect on the deduction for funding a charitable remainder annuity trust (CRAT) is similar to the effect on the deduction for funding a gift annuity, which is to say substantial and positive. It also reduces the likelihood that a CRAT will fail the 5% probability of exhaustion test. Unlike with a gift annuity, however, the IRS discount rate has no effect on how a CRAT's payments are taxed. In short, a rising IRS discount rate is unmitigated good news for CRAT donors.

The effect of a rising IRS discount rate on the deduction for funding a charitable remainder unitrust is negligible.

### **Charitable Lead Trusts**

The effect of a rising IRS discount rate on a charitable lead trust is identical to its effect on the charitable remainder trust, but in the opposite direction. For example, whereas the deduction for a CRAT that will pay two 70 year-olds for life has increased about 40% in the last 18

months, it has decreased about 40% in the last 18 months for a similar lead annuity trust (CLAT). So, the CLAT is becoming less attractive as the IRS discount rate goes up. As with the charitable remainder unitrust, the effect of a rising (or falling) IRS discount rate on the deduction for funding a charitable lead unitrust is negligible.

### **Retained Life Estate**

The effect of a rising IRS discount rate on the deduction for creating a retained life estate (RLE) is significant, but less dramatic than its effect on gift annuities, CRATs, and CLATs. Its direction is the same as for a CLAT: the greater the IRS discount rate, the lower the deduction for creating a RLE. So, for example, the deduction for creating a RLE for a 75 year-old is about 20% less using a 4% IRS discount rate than it is using a 1.4% rate. As I mentioned earlier, it is about 40% more when creating a gift annuity or CRAT for a 75 year-old.

### **Conclusion**

After several years of stagnation at very low levels, the IRS discount rate has been moving steadily upward since last fall and all indications are that it is likely to continue that trend. For gift planners, this means that the deductions available to donors of gift annuities and charitable remainder annuity trusts have increased noticeably over the last 18 months and are likely to continue to increase. You may want to point out this fact when talking with gift annuity prospects, and especially when encouraging gift annuity donors to make repeat gifts. You also may want to make it a point to ask gift annuity donors if they expect to itemize their deductions. If they don't, explain to them that they will receive greater tax-free payments if they elect to use the lowest available IRS discount rate for performing gift annuity calculations.

The deduction for donors of lead annuity trusts and retained life estates have decreased significantly during the same 18 months. If you have prospects who have been considering either of these kinds of gifts, it may be a good time to alert them that the longer they wait, the smaller the deduction they likely are going to be able to declare.

As always, the tax benefits are only one of a donor's many motivations for making a gift to your charity and rarely, if ever, is it the most important one. Get to know your donors – what their goals are, what they care about, why they give – and good gifts will follow.