

To: Our Charitable Clients  
From: Lawrence P. Katzenstein  
Date: October 3, 2011  
Re: October 7520 rate

As you may be aware, the section 7520 rate for October has dropped to an unprecedented low of 1.4%. The previous low was last December's 1.8%. As recently as May, the 7520 rate was 3.0%. (The historic high was the May, 1989 11.6% rate.) The 0.6% drop in the September section 7520 rate—down all the way from 2.0% to October's 1.4%—creates special opportunities for individuals with philanthropic interests. Charitable lead annuity trusts and charitable gifts of a remainder in a personal residence are particularly attractive now because of the low interest rate. However the low interest rate also makes some charitable vehicles less attractive or, in some cases, not available at all. Note that for all of the charitable planning vehicles, the 1.4% October rate can be used for gifts made in October, November or December.

### **Charitable Lead Annuity Trusts**

A charitable lead annuity trust is in many ways the opposite of a charitable remainder annuity trust: the trust provides for payment of an annuity interest to charity, typically for a term of years, with the remainder payable to other family members. It is both an estate planning device and a charitable giving vehicle. If a charitable lead annuity trust is established during life, the donor is making a taxable gift of the remainder. The lower the interest rate, the less the gift for gift tax purposes. If over the term of the trust the investment performance exceeds the section 7520 rate in effect when the trust is created, the value of the gift for gift tax purposes will be less than the value of the assets actually passing to family members, and the excess will be a free transfer to family members for transfer tax purposes. At the October 7520 rate, the investment performance must exceed only a 1.4% rate of return to result in a gift and estate tax free transfer to family members. That is why this low interest rate makes charitable lead annuity trusts so attractive now. You might want to make selected wealthy donors aware of the current attractiveness of charitable lead annuity trusts.

As charitable lead trusts are typically structured, the donor does not receive an income tax deduction for creating a charitable lead trust. But since the donor is not taxed on the trust income, the economic result is the same as if the income were received by the donor and then fully deductible. (An income tax deduction is available for the actuarial value of the charitable gift only if the trust is structured so that the donor is taxed on the income of the trust during the trust term even though the donor will not receive the income. This can be useful as a way of accelerating a charitable deduction into a high income year, such as the year in which the donor sells a business or has unusually high income for some other reason.)

Charitable lead trusts are a very technical subject and I can provide you with a more detailed outline and technical discussion if you wish.

### **Gifts of a Remainder in a Personal Residence**

The other charitable strategy which is particularly attractive given current low interest rates is a gift of a remainder in a personal residence or farm with retained life estate. With this gift, the donor deeds his or her personal residence to charity, reserving the right to live in the house for the remainder of the donor's lifetime. An income tax deduction is available for the actuarial value of the remainder. The lower the section 7520 rate at the time of the gift, the greater the income tax deduction. To illustrate how dramatically interest rates affect this kind of gift, assume a donor age 70 who wishes to contribute the remainder interest in her residence to charity. Assume also that the residential property has a fair market value of \$1,000,000, of which \$800,000 represents the value of the house and \$200,000 the value of the land. If the 7520 rate were 6%, the deduction would have been \$386,194. Using the October, 2011 interest rate of 1.4%, the deduction rises to \$627,490—a dramatic increase. You may want to make certain donors are aware of this opportunity. This makes a great deal of sense for a client planning to leave his or her estate to charity at death in any event. A gift of the remainder interest now generates a large current income tax deduction as well as an eventual estate tax deduction. In the rather rare case where the charity wishes eventually to acquire residential property from a donor in need of current income, the actuarial value of the remainder interest can be considered the purchase price of a charitable gift annuity. This will only make sense in specialized situations because it will require using current revenues to acquire a future gift.

### **And Now for the Bad News**

The bad news about the unusually low section 7520 rate is that certain gifts will now be less desirable than they were before. The income tax deduction for charitable gift annuity donors as well as donors to charitable remainder annuity trusts will be dramatically reduced. (Charitable remainder unitrusts are essentially unaffected by interest rate swings.) In addition, the unusually low interest rate creates certain traps for both charitable gift annuities and charitable remainder annuity trusts.

### **Charitable Gift Annuities**

The tax law provides that in order for the charity's gain on the sale of a charitable gift annuity not to be taxed as unrelated business income, the value of the annuity must be less than 90% of the value of the property exchanged for the annuity. Some gift annuities for younger donors, even those issued at American Council on Gift Annuities recommended rates, may not pass this test. You need to run the calculation and if necessary reduce the gift annuity rate to whatever level is necessary to generate a charitable deduction of 10% or higher. Annuities issued at American Council on Gift Annuities recommended maximum annuity rates will normally pass the 10% test. But as interest rates fall, it is important to make certain that the 10% test is met. New CGA rates became effective on July 1 (see details at [www.acga-web.org](http://www.acga-web.org)). The

new ACGA rate schedule notes that:

“While the Committee keeps a close eye on current economic activity, historically the Council has not made quick reactions to short-term economic fluctuations since charitable gift annuities are intended to be long-term in nature. If economic events warrant a change in assumptions that would affect the rates schedules, the Council will issue relevant communications. Please note that when the Applicable Federal Rate (AFR) falls to low levels, charities may have to reduce the gift annuity rates they offer in order to comply with the IRS 10% rule. With the AFR dipping below 3.2%, the rate at which the current schedules of gift annuity rates will pass the 10% test, annuities for younger donors, and many deferred payment gift annuities will no longer pass this test using the current schedule of rates. Charities will need to lower their gift annuity rates in these circumstances in order to pass the 10% test.”

But the news for CGAs is not all bad. Although the income tax deduction on purchase of a charitable gift annuity is lower when interest rates are low, the amount of each payment *excluded* from income under section 72 will be *higher*. So a non-itemizer or other donor who cares more about how much income is taxable than about the charitable deduction will find the charitable gift annuity especially attractive now. Those donors should elect to use the lowest available 7520 rate.

### **Charitable Remainder Annuity Trusts**

In addition to dramatically reducing the deduction for gifts to charitable remainder trusts, the low interest rate creates two possible traps. The first trap is that under the tax law, a qualifying charitable remainder annuity trust or unitrust must have a charitable remainder with an actuarial value of at least 10% of the value of the property transferred to the trust. This test becomes much more difficult to pass when interest rates are low. In addition, charitable remainder annuity trusts also have to pass a separate test requiring that there be no more than a 5% probability that the trust will be exhausted before the charitable remainder vests. This test also becomes more difficult to pass when interest rates are low. For example, at the October 1.4% 7520 rate, a charitable remainder annuity trust paying a 6% annuity to two individuals age 81 (assuming quarterly payments) flunks the 5% exhaustion test. Another example: at the October 1.4% 7520 rate, a 6.0% charitable remainder annuity trust created for a 79-year old beneficiary flunks the exhaustion test. In fact, a 73 year old cannot create a charitable remainder annuity trust at all at a 1.4% section 7520 rate because even at a 5% annuity level—the minimum permitted payout—a trust paying quarterly payments flunks the exhaustion test! It is extremely important that any charitable remainder annuity trust created pass both of these actuarial tests. The 5% exhaustion test does not apply to charitable remainder unitrusts or charitable gift annuities.

### **Turning Lemons into Lemonade**

In one respect, however, the low interest rate creates an opportunity for beneficiaries of

existing charitable remainder annuity trusts. The fact that the present value of the charitable remainder is now unusually low also means of course that the value of the annuity itself is quite high. There may be donors who would be willing to donate all or a portion of their remaining annuity interests to the charitable remainder beneficiary. They will be entitled in that event to a charitable deduction for the actuarial value of the annuity released, and that deduction is much enhanced because of the current low interest rate. For example, suppose a 70 year old beneficiary of a charitable remainder annuity trust paying \$6000 per year is willing to contribute her remaining life interest to the charitable remainder beneficiary. If she had made the gift in a month when the section 7520 rate was 8% her deduction would have been \$46,757. If she were to release her interest in October when the 7520 rate is only 1.4%, her deduction increases from \$46,757 to \$75,506. Note that the same is not true of a gift of a charitable gift annuity interest. That interest, unlike the annuity interest in a CRAT, is an ordinary income asset and the deduction will be limited to unrecovered basis in the contract.

A NOTE ABOUT UNITRUSTS. We have not discussed unitrusts in this memorandum because interests in unitrusts are affected only slightly (and in some cases not at all) by interest rates.