FINANCIAL STRATEGIES
For Estate Planning and Planned Giving
• Legislation
• Court decisions
• IRS developments

Winter 2017

Big Jump in Discount Rate Affects Charitable Deductions

The discount rate determined under **IRC §7520** that is used to determine the relative values of split interest charitable gifts increased to 2.4% in January—a 0.6% bounce from December and a full 1.0% more than it was as recently as September.

The discount rate has not been this high since May 2014. Generally, higher discount rates produce higher income-tax charitable deductions for gifts in which a donor reserves an income interest such as charitable gift annuities (**CGA**s), charitable remainder annuity trusts (**CRAT**s), and charitable remainder unitrusts (**CRUT**s).

Lower discount rates produce higher income-tax deductions for a gift of a remainder interest with a retained life estate (**RLE**) in a personal residence or farm. They also produce higher deductions for the charitable income interest in charitable lead trusts.

In the case of a nongrantor charitable lead trust in which the grantor does not retain a reversionary interest in the corpus, the deduction would be an estate- or gift-tax deduction. No income-tax deduction is available since the grantor is not taxed on the income of the trust. Conversely, in the case of a grantor charitable lead trust in which the donor does have a reversionary interest, the donor can claim an income-tax charitable deduction but remains taxable on the trust's income.

The 0.6% increase in the rate for January is the largest monthly change in the rate since it jumped to 2.0% in August 2013 from 1.4% the prior month. This alone can result in some substantial changes for the deductible portion of some gifts. If we assume certain gifts are made by a 74-year-old donor, the increase in the rate would produce changes in the available deduction for various types of gifts.

The numbers in the chart below show that the deduction increases meaningfully for the **CGA** and the **CRAT** when the discount rate is at 2.4% as opposed to 1.8%. The rate has little effect on the **CRUT**.

On the other hand, in the case of the gift of a remainder interest in a farm or personal residence with a retained life estate (RLE), the deduction drops by more than $20,000 at the higher discount rate.

Type of Gift	Deduction at 1.8% Discount Rate	Deduction at 2.4% Discount Rate
$100,000 one-life 5.7% gift annuity	$41,793	$44,243
$100,000 one-life 5% CRAT	$49,202	$51,162
$100,000 one-life 5% CRUT	$58,506	$58,612
$500,000 one-life RLE	$359,223	$338,328

Year	Income	Distributions	Charitable contribution deduction
1985	$700,304	$2,700	$384,976
1988	$ 46,830	$2,100	$ 77,900
1991	$187,610	$2,100	$159,441
1994	$138,445	$2,100	$139,450
1997	$175,008	$2,100	$146,933
2001	$125,465	$2,100	$ 99,148
2005	$159,306	$1,500	$125,274
2008	$112,403	$1,500	$ 86,864

Similar results would occur with a charitable lead trust. For example, the value of the deductible income interest, either for income-tax or estate- or gift-tax purposes, is substantially more when the rate is lower. Here is what happens with a $1,000,000 **CLT** that pays an annuity interest of $50,000 per year for 20 years:

Discount Rate	Deductible Amount
1.8%	$833,570
2.4%	$786,870

Donors have the choice of using the rate in effect for the month in which the gift is actually made or for either of the two previous months. Those contemplating a major split-interest gift will want to be sure to consider what discount rates are available to them and what the impact of their choice of rates will be.

Tax Court Sends Message: Say What You Mean and Mean What You Say

Harvey Hubbell executed his last will and testament in 1955 and died two years later. In 1960 the Ohio probate court approved final distributions from the estate, which included funds to create a trust that provided relatively small monthly annuity payments to several family members and friends for life.

In 2009 the income-tax return of the trust was audited by the Internal Revenue Service, which resulted in the denial of a claimed charitable deduction of $64,279 and the levying of a deficiency claim of $32,639. Representatives of the trust appealed that decision to the United States Tax Court [**Hubbell v. Commissioner, No. 2889-12S, (T.C. Oct. 13, 2016)**].

The 2009 gifts were not the first charitable contributions the trust had made. The trust had a history of significant gifts dating back to 1985. That year the trust had substantial income and indicated that it had made charitable contributions of $384,976. It continued to make intermittent gifts until 2009, the year in question in this case, as shown in the above chart:

The **IRS** did not dispute that the gifts had been made. It disputed whether or not the trust was authorized to make those gifts by the trust's governing instrument.

Item IV of the trust set out annuity provisions for a range of family and friends. Item V provided that the trust would continue until the death of the last surviving beneficiary under Item IV but also gave the trustees the authority to continue the trust exclusively for charitable purposes if they deemed it advisable:

> The trust last above mentioned shall terminate upon the death of the last person receiving benefits therefrom, except that if in the judgment of the then Trustees it is advisable to continue the trust, it may be continued for not longer than ten (10) years after such death. All unused income and the remainder of the principal shall be used and distributed, in such proportion as the Trustees deem best, for such purpose or purposes, to be selected by them at the time of each distribution, as will make such uses and distributions exempt from Ohio inheritance and federal estate taxes and for no other purpose.

As of 2009 there were still two of the named beneficiaries living. There was no language other than the language in Item V specifically authorizing the trustees to make charitable gifts. A later provision in the trust instrument gave the trustees the authority to create a foundation, but they had not done so as of the time of the audit of the 2009 return. As such, the **IRS** determined that the gifts were not deductible.

The Tax Court noted that the burden of proof was on the trust and that it needed to do three things to prevail: (1) identify the "governing instrument"; (2) show that the charitable contributions were paid "pursuant to" the terms of that instrument as required by **IRC §642(c)(1)**, under which the deduction was claimed; and (3) demonstrate that each contribution was paid for a charitable purpose under **IRC §170(c)**. The parties agreed that the trust satisfied (1) and (3), so only whether the gifts were made pursuant to the terms of the governing instrument was in question.

The trust argued that the court could go beyond the provisions of the document to determine Mr. Hubbell's intent because there was a "latent ambiguity" in the will that could make it possible to misinterpret intent without examining extrinsic facts. Essentially, the trust argued that even though the instrument did not expressly authorize charitable contributions until after the death of the last surviving annuity beneficiary, it also did not expressly prohibit the trustees from making such gifts.

The trust pointed out that the amount of the annuities paid to the individual beneficiaries was rather small compared to the total value of Mr. Hubbell's estate, leading to a conclusion that making charitable contributions would not jeopardize the trust's ability to fulfill the annuity obligations.

In addition, representatives of the trust had sought and received declaratory relief in 2014 from an Ohio court. The Ohio court issued the following declaration:

> The language of the Will, as written, providing for the administration of the Trust, authorizes, and has from the inception of the Trust authorized, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust.

The court rejected the contention that a relatively small amount of the annuities compared to the assets of the estate would indicate tacit approval of charitable gifts. It pointed out that there was also the possibility of a second trust—a marital trust for Mr. Hubbell's wife had she survived him. If that had happened, the trust in question would have only half as many assets. In addition, the court noted that Mr. Hubbell could have easily granted such permission if he so intended.

The Tax Court indicated that "for there to be an 'ambiguity' in a will, the words of the will must have two or more meanings, they must be understood in more than one way, or they must refer to two or more things at the same time. Boulger, 377 N.E.2d at 757."

The Tax Court offered this definition of a latent ambiguity:

> A latent ambiguity is a defect which does not appear on the face of language used or an instrument being considered. It arises when language is clear and intelligible and suggests but a single meaning, but some intrinsic fact or some extraneous evidence creates a necessity for interpretation or a choice between two or more possible meanings, as where the words apply equally well to two or more different subjects or things.

It found no such ambiguity here. According to the court, "The trust is asking the court to rewrite the will." The Tax Court also chose to disregard the finding of the Ohio Court. It determined that since "there is no ambiguity, there is no need to turn to extrinsic evidence—and the testator's intent must be determined from the will."

So what is the lesson of Hubbell? If there are specific intentions inherent in the creation of a governing instrument, it is good practice to state them as expressly as possible.

IRS Releases 2017 Brackets—For Now

The **IRS** has released the federal income-tax brackets for 2017. Adjusted for inflation—which has been minimal—the new brackets reflect very little change from the brackets that were in effect for 2016.

For instance, the 25% bracket for single taxpayers for 2017 tops out at $91,900, up just $750 from $91,150 in 2016. Similarly, the top end of the 25% bracket for married taxpayers filing jointly has increased just $1,200 from $151,900 in 2016 to $153,100 in 2017.

Standard deductions for 2017 are $12,700 for married individuals filing jointly, $6,350 for singles and married individuals filing separately, and $9,350 for heads of household. There is an additional standard deduction of $1,250 for taxpayers who are 65 or older or blind.

What Will the Future Hold? While tax rates and other components of the tax system are already firmly in place, there is significant anticipation that changes may be coming. Tax reform was a major theme of the presidential campaign, and the new administration and the Republican Party have advanced an outline of multiple proposed changes.

At this point any extended discussion of what those potential changes might be would be speculation. However, the proposals that have been put forth do seem to have common elements of fewer and lower federal tax brackets and higher standard deductions.

Such changes would, of course, have important implications for charitable planning. As we wait to learn specifics, taxpayers with charitable objectives will want to track potential tax changes carefully.

Top Range of Federal Income-Tax Brackets

Rate	Single	Married Filing Jointly	Head of Household
10%	$9,325	$18,650	$13,350
15%	37,950	75,900	50,800
25%	91,900	153,100	131,200
28%	191,650	233,350	212,500
33%	416,700	416,700	416,700
35%	418,400	470,700	444,550
39.6%	no maximum	no maximum	no maximum

Briefly …

ACGA Holds Steady on Suggested Rates. At its November board meeting the American Council on Gift Annuities made no changes in suggested maximum rates on gift annuities. Charities are free to set their own rates schedule, but many do choose to follow the ACGA suggested rates.

In determining its recommendations on suggested maximum rates, ACGA considers the assumed return on a model portfolio in which gift annuity reserves would theoretically be invested. The largest components of that model portfolio are 10-year Treasuries, accounting for 55% of the total.

The 10-year Treasury rose significantly over the last six months of 2016, with daily rates climbing from below 1.4% in July to more than 2.6% in December. Much of that increase came after the presidential election, with the rate just over 1.8% on election day.

This increase in the 10-year Treasury may portend a rise in the suggested maximum charitable gift annuity rates. Because the 10-year Treasury represents such a large portion of the assumed model portfolio, a substantial increase has a significant impact on the assumed return. A change of one percentage point in the rate would result in a 0.55% increase in the total assumed return. Returns on equity make up 40% of the formula, but it is based on long-term historical averages that are essentially static.

The Rates Committee of ACGA regularly monitors all of the components of the model portfolio. While there is precedent for changing the rate between board meetings, any change is typically made at semiannual meetings (the next of which is scheduled for April).

Private Letter Ruling Finds No UBTI. An exempt organization requested rulings on the effect of a sale of assets and granting of licensing rights, which resulted in receipt of payments for those rights (PLR 201644019).

The organization sold assets to a partnership formed by a corporation in which it held all the stock and another unrelated corporation. Proceeds of the sale were used for the exempt purposes of the organization. The organization has licensed to the partnership certain of its trademarks, trade names, and other intellectual property in exchange for royalty payments. The partnership will also be leasing space from the exempt organization.

The ruling confirmed that the activities contemplated by the organization after the sale of the assets would be consistent with its exempt purposes. It also concluded that the sale of the assets would not generate unrelated business taxable income (UBTI), saying the sale will not result in unrelated business taxable income to the organization because the sale is not a business that is regularly carried on within the meaning of §512(a)(1) of the Internal Revenue Code.

Similarly, the ruling determined that the payments received pursuant to granting licensing rights constituted royalties. It noted that computation of unrelated business taxable income under §512(a)(1) of the Code generally excludes royalty income. Rent payments would also not be UBTI because the organization did not have a controlling interest in the partnership. Finally, the IRS determined that the activities of the partnership should not be attributed to the organization.

__Financial Strategies__ is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep these planners up to date on developments in estate planning as they relate to testamentary and lifetime plans in support of qualified charities.

The Diabetes Research Institute Foundation supports the Diabetes Research Institute at the University of Miami Miller School of Medicine, an international center whose mission is to develop and rapidly apply the most promising research to treat and cure those now living with diabetes.

For additional information please contact:
Jill Shapiro Miller
Vice President of Gift Planning
The Diabetes Research Institute Foundation Offices
200 S. Park Road, Suite 100
Hollywood, Florida 33021
Dri.Giftplans.org
(954) 964-4040 or (800) 321-3437 or
e-mail jshapiro@drif.org

DIABETES RESEARCH INSTITUTE

Edited by André R. Donikian, JD, and Robert L. Coffman, JD