WILLMS, S.C.

LAW FIRM

MEMORANDUM

TO: Clients and Friends of Willms, S.C.

FROM: Atty. Andrew J. Willms

DATE: March 10, 2014

RE: Lowering Income, Capital Gain, and Medicare Taxes with Charitable Trust

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Introduction

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA). While this new law ended the temporary nature of the individual tax rates that had been in place since 2001, it also raised those rates and eliminated some deductions for taxpayers whose income exceeds certain thresholds. ATRA also expanded Medicare taxes by adding 3.8% surtax on "net investment income" and raised the top capital gain tax rate to 20%.

Fortunately, one thing ATRA did not do is limit the deduction for contributions to qualified charities. Generally speaking, donations to qualified charities are still fully deductible for federal income tax purposes.

As was the case before ATRA, gifts of less than the donor's entire interest in property do not qualify for the income tax, gift tax, or estate tax charitable deduction unless the gift qualifies for an exception to the "partial-interest rule". The most significant exception to the partial interest rule is for gifts to charity made through a charitable trust that meets statutory requirements set forth in the Internal Revenue Code.

There are two types of split interest charitable trusts that qualify for the charitable deduction. They are known as "charitable remainder trusts" and "charitable lead trusts". In appropriate circumstances these charitable trusts may benefit both individuals and charities without violating the partial interest rule. A discussion of both of these types of trusts follows.

Charitable Remainder Trusts

A charitable remainder trust (or "CRT") is an irrevocable trust that annually distributes between 5% and 50% of the trust assets to a non-charitable beneficiary (such as the person who creates the trust). The annual distributions can be made for life or for a specified

period of up to 20 years, after which the trust terminates and the remaining assets are distributed to the charity.

The annual payments from a CRT may be based on a percentage of the initial value of the trust (an "annuity trust"), or on the annual value of the trust assets in the year in which the payment is made (a "Unitrust"). A CRT can also be constructed so that payments are made to the donor for his lifetime and then to his or her spouse for their lifetime, provided that the value of the charitable remainder interest must be worth at least 10% of the net fair market value of all property transferred to the trust.

CRTs are not subject to federal income, capital gain, or Medicare taxes. As a result, if appreciated assets that have been contributed to a CRT are sold, the full proceeds can be reinvested and used to make the annual payments to the non-charitable beneficiary. Not surprisingly, distributions from a CRT are includable in the taxable income of the recipient, but the ability to defer the obligation to pay the tax means there are more assets available on which to earn a return. In addition, the ability to spread the recognition of the income for tax purposes out over a long period of time can result in lower tax rates applying to that income.

Charitable Lead Trusts

A charitable lead trust ("CLT") is the opposite of a CRT in the sense that with a CLT the annual payments from the Trust are made to charity, while the assets that remain in the trust after the annual payments end are distributed to individuals named in the trust agreement. As a result, a CLT is particularly well-suited to persons who traditionally make gifts to charity each year.

If a CLT is structured as a "non-grantor trust", then the income earned on the trust's assets is not subject to federal income or capital gain taxes. In addition, the proposed regulations for the net investment tax allow all trusts to deduct qualifying payments to charities before calculating their net investment income. Thus, the remainder of the charitable lead trust is able to grow without incurring the 3.8% net investment tax on the amount distributed to the charity each year. However, a donor to this type of CLT will not receive a charitable deduction for the amount contributed to the trust.

A CLT can also be structured as a "grantor trust" for federal income tax purposes. In that event the donor can claim a charitable deduction for the value of the charitable payments to be made from the trust. However, the net income of the trust is included in the grantor's gross income each year, although the grantor can deduct the present value of the charity's income interest in the year of the gift (subject to certain limitations).

Another tremendous tax advantage to a CLT is the ability to deduct the value of the payments to be made to charity when calculating the amount of the gift to the persons who

receive the assets that remain in the trust when the charitable payments end. Today's low interest rates serve to significantly magnify this benefit.

Conclusion

After years of uncertainty, the American Taxpayer Relief Act added some welcome permanency to the Internal Revenue Code (at least for now). For wealthier individuals that certainty came at the cost of new taxes and higher tax rates. As the above discussion indicates, charitable trusts can help lessen ATRA's sting. The best reason for utilizing these strategies remains unchanged however; namely the opportunity they afford to support worthy charitable organizations in their efforts to do good and help others less fortunate than ourselves.

I hope you have found the information contained in this memorandum to be helpful. Please contact us with questions or if you would like more information.

END OF MEMO