

Tax Briefs

Levin & Weiser, LLC
Attorneys and Counselors at Law

950 S. Cherry St., Suite 1000
Denver, Colorado 80246
(303) 504-4242
Fax (303) 691-9719
www.lw-law.com

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● **LEAD STORY: Lowest Present Value Rate In the History of the Internal Revenue Code! Charitable Giving Opportunities Abound!**

Last month Levin & Weiser reported that the § 7520 rate, an important component of a number of estate planning strategies, including grantor retained annuity trusts (see the June 16, 2003 edition of *Tax Briefs*) reached an all time low at 3.6%. A low rate provides individuals with several significant estate planning opportunities. For the month of July, the § 7520 rate has fallen to 3.0% (see below) - the lowest rate for determining the present value of certain interests in the history of the Internal Revenue Code by 0.5%! Prior to the enactment of § 7520, the rate was legislatively established and rarely varied (four changes in thirty-seven years). The lowest legislatively enacted rate was 3.5% in 1952.

One area of estate planning significantly affected by a low § 7520 rate involves charitable gift planning, particularly with regard to **charitable lead trusts** and **charitable remainder trusts**.

Charitable Lead Trusts

A charitable lead trust is a trust in which income is paid to one or more charitable beneficiaries for a term (the "lead interest"), and any remaining trust property at the expiration of the term (the "remainder interest") is paid to one or more non-charitable beneficiaries. In addition to satisfying a grantor's charitable objectives, the charitable lead trust provides significant tax benefits.

In general, the primary tax benefits of a charitable lead trust are a gift or estate tax charitable deduction for the value of the lead interest, and the potential removal of appreciating assets from the grantor's taxable estate. The grantor is generally not entitled to an income tax charitable deduction with respect to the lead interest; however, alternative structures provide a grantor with an immediate income

tax charitable deduction, provided, the grantor remains taxable on the income subsequently earned by the trust. There is flexibility in providing for the terms and benefits of a charitable lead trust.

To obtain any income, estate or gift tax charitable deduction, the charitable lead trust must provide for a payment to one or more charitable beneficiaries in the form of (1) a guaranteed annuity or (2) unitrust interest. A guaranteed annuity grants the charitable beneficiary an irrevocable right to receive a sum payable no less frequently than annually for a term of years, or for the life or lives of one or more individuals. A unitrust interest is an irrevocable right to receive a sum payable no less frequently than annually for a term of years, or for the life or lives of one or more individuals, equal to a fixed percentage of the net fair market value of the trust assets. Because unitrust payments are based on a fixed percentage of the fair market value of trust assets, payments increase as trust assets appreciate in value, or decrease as trust assets depreciate in value.

Any income, estate or gift tax charitable deduction is equal to the present fair market value of the guaranteed annuity or unitrust interest. In the case of a charitable lead *annuity* trust, the present value of the remainder interest (that portion of the transfer to *noncharitable* beneficiaries and subject to estate and gift taxes) is determined with regard to the § 7520 rate. The lower the § 7520 rate, the lower the value of the non-charitable remainder interest and related gift or estate tax liability, and the higher the available charitable deduction.

In the case of a charitable lead *unitrust*, the § 7520 rate is not a significant factor in calculating the value or either the lead or remainder interests. Thus, a unitrust is often more desirable during times of high interest rates.

A grantor may contribute income producing or non-income producing property to a charitable lead trust. Often, income producing property is preferred as it will provide a source of income necessary to satisfy the guaranteed annuity or unitrust payments. Furthermore, from the standpoint of the non-charitable remainderman, the ideal gift to a charitable lead trust consists of property appreciating at or above the general rate of inflation and annuity or unitrust payout rate. For example, property with a value of \$1 million is placed in a 10-year charitable lead annuity trust, paying an annual annuity of \$60,000. If the property appreciates at a rate of 15% each year, it will be worth approximately \$4 million at the expiration of the annuity period. The remaindermen receive a substantial windfall because only \$600,000 was paid out by the trust over the annuity period. As a result, considerable gift and/or estate taxes are avoided. This result is maximized when the § 7520 rate is at an all-time low.

Charitable Remainder Trusts

A charitable remainder trust is a trust in which the lead interest, or income therefrom, is paid to one or more non-charitable beneficiaries (including the grantor) for a term, and the remainder interest is paid to one or more charitable beneficiaries. Like the charitable lead trust, the charitable remainder trust helps civic minded individuals satisfy their planned giving objectives and provides significant tax benefits.

Like the charitable remainder lead trust, there are two types of charitable remainder trusts: (1) the charitable remainder annuity trust, and (2) the charitable remainder unitrust. The annuity and unitrust interests are similar to those described above. However, a charitable remainder unitrust may provide that the income payable to the non-charitable beneficiary is equal to the lesser of a fixed percentage of the fair market value or trust assets or trust accounting income (a “net income only” unitrust). In the case of a net income only trust, the unitrust may provide that to the extent accounting income is less than a fixed percentage of fair market value of trust assets, the deficiency is “made-up” in future years (such trusts are known as “NIMCRUTs”).

The grantor of an *intervivos* (lifetime) charitable remainder trust is entitled to an immediate income and gift tax charitable deduction for the current fair market value of the remainder interest given to the charitable beneficiary. However, if the lead interest is given to someone other than the grantor, gift taxes

may be due. Unlike the charitable lead trust, a charitable remainder trust is generally exempt from income tax. One important feature of the charitable remainder trust, is that appreciated trust property can be sold tax-free.

In the case of a charitable remainder annuity trust, subject to certain exceptions, the annuity amount may not be less than 5-percent nor more than 50-percent of the initial fair market value of the trust property. In addition, the present value of the remainder interest must be at least 10-percent of the fair market value of the contributed assets.

In the case of a charitable remainder unitrust, because unitrust payments are based on a fixed percentage of the fair market value of trust assets, payments increase as trust assets appreciate in value, or decrease as trust assets depreciate in value. Therefore, the holder of the lead interest general prefers an annuity trust during times of deflation or less significant appreciation. The fixed unitrust percentage may not be less than 5-percent nor more than 50-percent of the initial fair market value of trust property. Additionally, the present value of the remainder interest must be at least 10-percent of the fair market value of the property initially transferred to the trust.

Like charitable lead trusts, charitable remainder annuity trusts are sensitive to the § 7520 rate, whereas charitable remainder unitrusts are relatively unaffected. However, the § 7520 rate inversely affects charitable remainder annuity trusts, as compared to the charitable lead annuity trust. Here is how it works: When the § 7520 rate is low the present value of the charitable remainder interest is low, resulting in a lower charitable deduction and greater gift or estate tax liability if the lead interest is payable to a non-charitable beneficiary other than the grantor. Therefore, in times of low interest rates a charitable remainder unitrust generally provides greater tax benefits than a charitable remainder annuity trust.

A Note On Gift Annuities

The § 7520 rate has a similar effect on charitable gift annuities as charitable remainder annuity trusts. A charitable gift annuity is a charitable organization's promise to pay fixed payments over time to one or two life "annuitants" in exchange for cash or other property. The two aspects to a gift annuity include the outright charitable donation, and purchase of a fixed income annuity contract. Unlike the charitable remainder annuity trust, annuity payments may be made using any funds of the charitable organization. In other words, the annuity contract is a general obligation of the charitable organization and repayment is not restricted solely to income from previously contributed property.

The similarities between a gift annuity and charitable remainder annuity trust seem to indicate that the gift annuity is often less attractive when interest rates are low.

Summary

Given the incredibly low § 7520 rate, those interested in pursuing their charitable giving objectives need to consider the impact the rate will have on their plans. Those wishing to provide charitable organizations with immediate cash flow (charitable lead trusts) will likely see greater tax advantages from the annuity version. On the other hand, those wishing to guarantee some form of income interest for a period of time or remainder of their lives, and provide a charitable organization with a future interest in property (charitable remainder trusts) should see greater benefits from a charitable remainder unitrust. Lastly, this is generally not an ideal time to acquire a charitable gift annuity (at least from the perspective of the taxpayer).

Readers should note that the § 7520 rate is only one factor in determining the most tax-beneficial means of planning your charitable giving. For example, age and term of the lead interest often play crucial roles in determining the tax consequences. Always ask your tax advisor to consider all alternatives before settling on one strategy.

● IRS Releases Applicable Federal Rates for July 2003

The following are the various prescribed rates for federal income tax purposes for July 2003, as set forth in Revenue Ruling 2003-71.

	Annual	Semiannual	Quarterly	Monthly
Short-Term				
AFR	1.23%	1.23%	1.23%	1.23%
110% AFR	1.35%	1.35%	1.35%	1.35%
120% AFR	1.49%	1.48%	1.48%	1.48%
130% AFR	1.61%	1.60%	1.60%	1.59%
Mid-Term				
AFR	2.55%	2.53%	2.52%	2.52%
110% AFR	2.80%	2.78%	2.77%	2.76%
120% AFR	3.06%	3.04%	3.03%	3.02%
130% AFR	3.32%	3.29%	3.28%	3.27%
150% AFR	3.84%	3.80%	3.78%	3.77%
175% AFR	4.48%	4.43%	4.41%	4.39%
Long-Term				
AFR	4.17%	4.13%	4.11%	4.09%
110% AFR	4.59%	4.54%	4.51%	4.50%
120% AFR	5.02%	4.96%	4.93%	4.91%
130% AFR	5.44%	5.37%	5.33%	5.31%

The following table applies for purposes of determining the original issue discount on tax-exempt obligations under IRC § 1288(b):

	Annual	Semiannual	Quarterly	Monthly
Short-term adjusted AFR	1.09%	1.09%	1.09%	1.09%
Mid-term adjusted AFR	2.29%	2.28%	2.27%	2.27%
Long-term adjusted AFR	4.05%	4.01%	3.99%	3.98%

The adjusted long-term exempt rate under IRC § 382 is 4.05% and the rate for ownership changes during the current month is 4.45%.

For purposes of the low-income housing credit the 70% present value credit percentage is 7.78%, and the 30% present value credit percentage is 3.33%.

The applicable federal rate for determining the present value of an annuity, an interest for life or a term for years, or a remainder or reversionary interest (under IRC § 7520) is 3.0%.

The blended annual rate for 2003 (IRC § 7872(e)(2)) is 1.52%.

● House of Representatives Votes to Repeal Estate Tax

On June 18th the U.S. House of Representatives voted 264 to 163 to approve a bill repealing the sunset provision in the estate tax. As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) the estate tax is scheduled for repeal in 2010, only to reappear in the form of pre-EGTRRA law in 2011. The re-emergence of the estate tax in 2011 is due to Senate budget constraints designed to curb budget deficits (for example, see the May 23 edition of *Tax Briefs*).

The bill was supported by most House Republicans and joined by 41 Democrats, but it is unlikely and unexpected that the measure will pass the Senate. A similar effort to repeal the estate tax, but with a smaller cost, fell six votes shy of passage in the Senate last June. With only 51 Republicans in the Senate it will be difficult to find nine Democrats needed to pass the measure.

Meanwhile, Democrats countered with an alternative to estate tax repeal. Democrats called for increasing the estate tax exemption to \$3 million, which they claim will exempt nearly 99-percent of all estates from being taxed. The Democrats’ plan would take effect on January 1, 2004, while the Republican version would not be effective until January 1, 2011.

● In Summary . . .

The European Union’s Trade Commissioner, Pascal Lamy, expressed satisfaction with U.S. efforts to repeal the FSC Repeal and Extraterritorial Income Exclusion Act, thus complying with a World Trade Organization ruling against the act. Legislators have indicated an intent to repeal the act by September 30th. . . . **The Internal Revenue Service (IRS) issued a consumer alert**, warning taxpayers about a scam targeting potential recipients of child tax credit advance checks expected to be issued in July and August. The scam involves a telephone call in which a person offers to speed up payment of the advance checks in exchange for a \$39.99 charge to a credit card. . . . **House lawmakers approved a new bill to create two tax-preferred health savings vehicles.** The plan, approved by a vote of 237 to 191, at a cost of \$174 billion, creates a new health savings account (HSA) and health savings security account (HSSA) designed to benefit both uninsured and employer sponsored health plan participants. Individual contributions would be tax deductible, even if the taxpayer does not itemize expenses. Employer contributions would be tax free and would be tax-free if used for “qualified” medical expenses. . . . **The IRS announced a partial amnesty program** under which nonresident aliens and foreign corporations who previously failed to file U.S. tax returns (but should have), can file U.S. returns without having to pay the strict late-filing penalty exclusive to these taxpayers that disallows deductions and tax credits. U.S. tax returns must be filed by September 15, 2003 to take advantage of the amnesty program. Statutory interest and additional penalties may be imposed. . . . **U.K. Prime Minister Tony Blair** recently warned middle-class families that they might have to pay more taxes to boost public services.

Q&A

If you have any questions on any tax matter feel free to write us at info@lw-law.com. We can’t answer every question we receive, but if you ask a short question that can be answered concisely, we’ll consider it for publication. Remember, questions answered are only intended to provide general information. Consult with your attorney before acting on information you see here.

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