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Charitable Planning in Light of Possible Sweeping Tax Reform Legislation

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INTRODUCTION

Estate planning advisors need to be cognizant of potential tax reform legislation and related regulatory trends in the charitable sector when advising clients who are considering making substantial planned gifts. While there is much uncertainty with respect to the development of any national legislation, it is clear that President Trump and the Republican-controlled Congress want to enact substantial federal tax reform. Such legislation could provide the most sweeping changes since President Reagan signed the 1986 Tax Reform Act.

Many of the proposals could impact future tax benefits of current charitable planned giving. The following article discusses various tax reform proposals from the current administration and the Republican party and also trends in the regulation of tax-exempt organizations and how such proposals and trends could affect the tax and related benefits of planned charitable gifts in the future.

FEDERAL ESTATE TAX REPEAL

President Trump has proposed the complete repeal of the federal estate tax and this is certainly something that has been strongly desired by Congressional Republicans for many years.[1] While there is no guarantee that President Trump and Congressional Republicans will achieve any tax reform, many tax commentators believe that estate tax repeal has a very strong likelihood of occurring. But any measure of tax reform is all in the details. Such success may be in the form of a 10-year sunsetted repeal similar to what was done in 2001, which means the estate tax could come back with a vengeance in 2028. This sunset would address the requirement that any permanent tax reform that causes a loss of revenue must have at least 60 votes in the Senate, and the Republican party currently only has 52 Senators. In any event, many view federal estate tax repeal as the most likely tax reform legislative initiative to be passed in this Congress.

What would this mean for charitable bequests? The Congressional Budget Office at one time concluded that eliminating the estate tax would reduce the amount bequeathed to charity, decreasing donations by 6% to 12%.[2] The net effect of having no estate tax savings would be to increase the effective cost to a donor's family of leaving substantial sums to charity.

Such repeal could result in a greater emphasis on obtaining income tax savings for charitable planned gifts instead of estate tax savings. One type of inherited property that will most likely remain subject to income tax is income in respect of a decedent. The primary assets in this category are a qualified retirement plan benefits or an individual retirement account. Neither escapes income taxes on the death of the participant but instead are subject to income tax

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[1] *See Tax Reform That Will Make America Great Again*, available at https://assets.donaldjtrump.com/trump-tax-reform.pdf. The document merely states, "The death tax punishes families for achieving the American dream. Therefore, the Trump plan eliminates the death tax." See also *2017 Tax Reform for Economic Growth and American Jobs* announcement on April 26, 2017, in which the Trump Administration proposes to "repeal the death tax," available at http://www.washington.edu/federalrelations/files/2017/04/WHfactsheet04262017.pdf.

[2] Congressional Budget Office, *The Estate Tax and Charitable Giving*, at 8 (July 2004), https://www.cbo.gov/sites/default/files/108th-congress-2003-2004/reports/07-15-charitablegiving.pdf.

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when withdrawn. While there has always been a special tax advantage associated with leaving retirement accounts to charities (and thus avoiding income tax on withdrawal), with the repeal of the estate tax there would be an added incentive to consider the use of such assets for charitable bequests if the donor is interested in obtaining tax savings resulting from the donor's charitable bequests.

The new focus on income tax savings resulting from estate tax repeal also means that advisors should provide tools to their clients interested and willing to make irrevocable current testamentary pledges to obtain current income tax deductions for charitable set-asides in the future. Common tools in this regard include charitable remainder trusts, charitable gift annuities, and irrevocable gifts of remainder interests in property. These charitable planning techniques have the added advantage of providing the donor with a current income tax savings. If the donor simply waits to leave a similar economic benefit at his death to his favorite charity, such a testamentary gift will not result in any federal tax savings if the estate tax is repealed.

Advisors need to carefully review and draft any formula in an estate plan that looks to the federal estate tax in effect at death in determining how much is left to charity, because of the possibility of estate tax repeal coupled with the possibility of its reinstatement in the future. (For example, what would happen to a zero out formula that calls for charitable bequests to receive the minimum amount necessary to avoid federal estate tax if upon the donor's death there is no federal estate tax? This may result in litigation over interpretation of the decedent's intent or in the least extensive negotiations among the designated charities and the non-charitable beneficiaries over how to allocate the estate.) There should be serious discussion with the donor over how he would like his estate distributed in the event of estate tax repeal and a special provision added to his will and/or trust to address this. The donor needs to also understand that the estate tax could be repealed and later reinstated and the formula should address both possibilities.

Formulas may also address the funding and annuity rate of testamentary charitable lead or charitable remainder trusts based on applicable rates at death and the federal estate tax at death. Again, the donor and draftsperson need to address how such funding and annuity rates should be determined if there is no federal estate tax.

Some estate plans may not have an actual formula but the donor may have directed a specific allocation of the donor's estate between charity and non-charity based on an understanding of the estate tax rates and exemptions in effect at the donor's death. This too should be revisited in light of the possible estate tax repeal and to determine if the allocation would in that event still reflect the donor's goals. For example, if the donor has a net worth of $7.5 million and decides to leave $2.5 million to the donor's favorite charity in light of his understanding that the estate tax exemption amount is approximately $5 million, this needs to be reconsidered for the possibility of no federal estate tax.

Federal estate tax repeal could potentially have an indirect effect on possible charitable planned giving when considering life insurance that was obtained by the donor to help cover liquidity needs caused by a substantial estate tax liability. While there are many positive financial attributes for keeping the insurance in any event for the benefit of the family because of projected internal rates of returns, the donor/insured may view this insurance as an unnecessary windfall to the donor's family and may want to consider ways to possibly donate the insurance policy to the charity, or cash in the policy and donate the net surrender proceeds to charity.

However, estate tax repeal would not change the planning associated with irrevocable insurance trusts often referred to as "wealth replacement trusts" that are funded to replace the amounts passing to charities at the death of the donor from a charitable remainder trust.

When considering formulas and related planning for possible estate tax, donors need to also understand that while their estates may have no federal estate tax liability, they may be domiciled in states that assess a state estate tax with corresponding charitable estate tax deductions. There are currently 16 states that assess estate tax. Even with federal estate tax repeal, there can remain estate tax savings at the state level for donors in such states.

In the end, if there is repeal of the federal estate tax, donors must understand the loss of tax benefit resulting from testamentary charitable gifts so that the effective cost to the family is higher. But with this education also comes a fundamental acknowledgment that tax savings alone may not necessarily motivate a major planned gift. Instead, there will be a greater premium on the potential charitable donee to provide a compelling case for its mission's impact and the sustainability of its organization. Avoiding federal estate tax will simply not be the compelling reason for a major testamentary gift. A donor will also often be interested in ways that the testamentary gift will provide the donor and the donor's family with a lasting legacy and, again, tax savings will not be as important in determining how much to give and the benefactors of such a gift.

One corollary to estate tax repeal that bears mentioning is the possibility of federal gift tax repeal. President Trump's proposal did not include such re-

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peal and it is considered highly unlikely that such a repeal will occur out of concern by the IRS that individuals would use tax-free gifting as a means to shift income taxation to lower rate individuals and do related transactions to lower the overall income taxation, especially with respect to capital gains transactions. If the federal gift tax is retained, high net worth donors may be especially interested in finding ways to transfer wealth without incurring gift tax and, if so, they will be interested in ways to leverage the available gift tax lifetime exemptions (currently $5.49 million).[3] Lifetime planned giving with charitable split interest trusts may be a helpful tax planning vehicle especially when the individual and family are already philanthropic. For example, much has been written in recent years over the leverage resulting from use of charitable lead trusts in light of the positive economics for such trusts in historically low interest rate environments.[4] The leverage associated with such trusts can result in gift tax free transfer of wealth at the end of the charitable lead period.

REDUCTION IN FEDERAL INCOME TAX RATES

While the primary focus on income tax rates relates to corporate rates, the House Republican Tax Reform Blueprint would lower the federal individual income tax rates to a schedule of 12%, 25%, and 33%.[5] Such lowering of rates may have a greater hurdle than estate tax repeal because the revenue loss is much more substantial. With this said, there were suggestions last year that individuals should consider accelerating their charitable giving to 2016 to obtain higher tax benefits because of the possibility of lower rates in the future.[6] The donor advised fund sector probably benefitted the most from this suggestion because donors could make contributions to such funds and receive a current income tax deduction while not having to immediately distribute such funds to charities. (For example, a donor who normally gives $2,000 each year to the donor's college could contribute $10,000 to a donor advised fund, get an immediate tax deduction and then request annual distributions of $2,000 from the donor advised fund in each of the next five years to her college.) In any event, income tax rates and possible reform do need to be monitored when the donor wants to maximize tax benefits and is engaged in relatively constant charitable giving.

CAP ON ITEMIZED DEDUCTIONS

President Trump proposes an annual cap on itemized federal income tax deductions of $100,000 for a single person and $200,000 for a married couple. This possible cap should clearly be considered when counseling clients on major multiyear pledges because this could impact their tax savings in the future. Donors may be willing to take that risk and commit to the pledge especially if they are being encouraged to do so to support a major capital campaign. But again, it is best to not have a client surprised in the future when told that the deductibility of their contributions are capped. In addition, when designing a charitable giving plan for the client, one can consider possibly accelerating some contributions before the caps are effective and to schedule various multiyear grants in light of the possible caps.

While this cap will not likely affect the average American donor, it could have a serious effect on major giving. The Tax Policy Center estimates that this plan and related income tax proposals would reduce individual giving by 4.5% to 9 %, or between $13.5 billion and $26.1 billion if effective in 2017.[7]

POSSIBLE ADDITIONAL FEDERAL LEGISLATION AFFECTING CHARITABLE GIVING

Overall, President Trump's tax reform proposals are consistent with the Republican party's tax platform. But in recent years other proposals have arisen from various Republican members of Congress that suggest additional legislation or regulation that could substantially reduce the charitable tax deduction and also effect the operations of tax-exempt organizations.

For example, former House Ways and Means Chair David Camp in 2014 proposed to limit the charitable deduction for property to the donated property's adjusted tax basis, which would greatly reduce the tax

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[3] §2010(c) ($5 million, as adjusted for inflation); Rev. Proc. 2016-55, 2016-45 I.R.B. 707, §3.35 (for 2017). All section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder, unless otherwise stated.

[4] *See* Laura H. Peebles, *Integrating Charitable and Business Succession Planning*, 42 Est., Gifts & Tr. J. 119 (May/June 2017).

[5] *See A Better Way, Our Vision for a Better America*, 17 (June 14, 2016), https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf. See also *2017 Tax Reform for Economic Growth and American Jobs* announcement on April 26, 2017, in which the Trump Administration proposes to ''repeal the death tax,'' available at http://www.washington.edu/federalrelations/files/2017/04/WHfactsheet04262017.pdf.

[6] Bernie Kent, *Should You Pay Your 2017 Charitable Contributions in 2016*? Forbes (Nov. 19, 2016), https://www.forbes.com/sites/berniekent/2016/11/19/should-you-pay-your-2017-charitable-contributions-in-2016/#6f893b4a5234.

[7] Chenxi Lu, Philip Stallworth, and C. Eugene Steurle, *Both Clinton and Trump Would Reduce Tax Incentives for Charitable Giving*, Tax Policy Center (Nov. 4, 2016), http://www.taxpolicycenter.org/taxvox/both-clinton-and-trump-would-reduce-tax-incentives-charitable-giving.

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savings of donating highly appreciated property. In addition, Senator Chuck Grassley has frequently expressed concern over perceived excessive accumulation in charitable funds in university and hospital endowments and through the use of donor advised funds. He has called for ways to legislate or regulate such endowments and funds to encourage more distributions.

Advisors need to be aware of these various developments when advising clients on major gifts to endowments. Similarly, charities with substantial endowments need to be prepared for future changes that may require accelerated distributions.

Donor advised funds are also on various Congressional and IRS target lists for increased regulation. Despite substantial evidence to the contrary, there is a concern that such funds are being used for individuals to accumulate vast sums in these funds while obtaining substantial charitable tax deductions, instead of giving to charities. Thus, there is a strong likelihood of future legislation being enacted to force increased current distributions from such funds similar to required qualified distributions from private foundations. When advising clients on the formation and further funding of donor advised funds, one should acknowledge that various compliance rules (many of which are appealing to donors considering such donor advised funds) may likely change in the future. In addition to requiring annual distributions similar to §4942 applicable to private grant making foundations, future legislation may impose other rules on donor advised funds relating to the types of investments and overall investment management of these funds, in addition to the disclosure of the identities of donors to such funds (thus removing the anonymity some donors find appealing for their donor advised funds).

The IRA charitable rollover appears to be permanent.[8] Section 408(d)(8) generally allows IRA owners who are at least 70½ to roll over up to $100,000 each year to public charities. This can be especially appealing to donors who do not itemize but who are interested in giving all or a portion of their required minimum distributions of their IRAs directly to their favorite charities. If anything this tax benefit may be expanded with legislation that would allow for distributions to donor advised funds, which under current legislation do not qualify for IRA charitable rollover treatment.

It should also be noted that the Trump Administration's announcement on April 26, 2017 regarding tax reform indicated that the Trump Administration plan would "protect the home ownership and charitable gift tax deductions."[9] Time will tell as to what the administration actually meant, but it is presumed that it was attempting to address concerns in the real estate industry and charitable sector that these deductions may be detrimentally impacted by tax reform.

CONCLUSION

In the end, charitable planning like estate planning in general, presents challenges when facing uncertainty as to future federal tax legislation. There is now a premium on being as flexible as possible and in drafting to anticipate what would occur with future legislation that can impact the charitable deduction, such as the repeal of the federal estate tax. And with or without major federal tax reform, donors are increasingly looking to advisors to provide counsel that enables the donors to be as impactful in their charitable giving as possible.

The charitable gift paradigm is shifting to other ways of giving, including doing good through social responsible investing or social impact investing. In this regard, donors are interested in finding ways to be as efficient as possible in their giving and are interested in evaluating current structures, such as private grant making foundations, to determine if they can be more efficiently administered. Congress shares in this interest and is increasingly asking if the current system of American philanthropy is best serving the public. They are asking if the benefits of this system truly exceed the tax cost from granting the charitable tax deduction and tax-exempt status. The answers to this question will likely have an impact on future tax legislation with respect to the charitable deduction and charitable tax exemption.

Donors are embarking on a potentially whole new world of charitable giving and it is incumbent on their advisors to be well versed on current developments in this area and possible legislation and regulations in the future.

[8] After a series of two-year extensions, Congress made the charitable rollover provision permanent in the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §112.

[9] *See 2017 Tax Reform for Economic Growth and American Jobs* announcement on April 26, 2017, available at http://www.washington.edu/federalrelations/files/2017/04/WHfactsheet04262017.pdf.

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With this said, philanthropy has contributed greatly to so many advances in the arts, education, health care, child care, the environment, and, in general, has addressed so many related serious needs of our society. There is no reason why this cannot continue, but there is also no reason why the mechanisms for delivering charitable contributions to our society cannot be improved. Advisors can play such an important role in guiding their clients on the most effective charitable giving tools that comply with federal and state law while providing as much flexibility as possible to ensure maximum tax benefits from future planned gifts.

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