

How the 3.8% Medicare Surtax Affects Charitable Giving

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Agenda

Background

Net Investment Income (NII)

Charitable Remainder Trusts

Pooled Income Funds

Charitable Lead Trusts

- Non-grantor
- Grantor

Charitable Gift Annuity

Charitable Planning



Net Investment Income (NII)

3.8% Surtax Imposed on Three Classes of Income

- Gross income from interest, dividends, rents, royalties and annuities
- Gross income from:
 - Passive activity, or
 - Trade or business of trading in financial instruments or commodities
- Net gain



Net Investment Income

Includes	Does NOT Include
Interest	Salary, wages or bonuses
Dividends	Distributions from IRAs or qualified plans §1411(c)(5)
Annuity distributions	Any income subject to self-employment tax §1411(c)(6)
Rents	Income from active business
Royalties	Gain on sale of active interest in partnership or S corporation
Net capital gain derived from disposition of property (other than property held in trade or business)	Items otherwise excluded or exempt from income under income tax law, such as interest from tax-exempt bonds, capital gain excluded under §121 and veteran's benefits
Trade or business income from passive activity	
Income or gain from investment of working capital	
Income from trade or business of trading in financial instruments or commodities	
LESS: "properly allocable" expenses §1411(c)(1)	

Surtax Background: Does Not Apply

Surtax Does Not Apply to Fully Charitable Trusts

- §1411(e)(2); Congressional Joint Committee on Taxation, JCX-18-10 p. 135
- Where all of unexpired interests are devoted to at least one
 - Religious, charitable, scientific, literary, or educational purposes
 - Effort to foster national or international amateur sports competition (but only if no part of its activities involve provision of athletic facilities or equipment)
 - Prevention of cruelty to children and animals



Surtax Background: Does Not Apply

Does Not Apply to Charitable Remainder Trusts (CRT)

- Exempt from income tax under §664
- Income earned by CRT before 1/1/2013 is exempt from surtax. Prop. Reg. 1.1411-3(c)(2)(iii); Prop. Reg. 1.1411-3(g).
- NII of beneficiary attributable to beneficiary's annuity or unitrust distribution from CRT shall include amount equal to lesser of
- Total amount of distributions for taxable year, or
- Current and accumulated net investment income of CRT. Prop. Reg. 1.1411-3(c)(2)(i)



Surtax Background: Does Apply

Surtax Does Apply to Non-grantor Charitable Lead Trusts (CLT)

- May be partially or entirely avoided by required annual distributions to charities



Charitable Remainder Trust

CRT is Exempt from Tax

CRT Income Beneficiaries Subject to Tax

- Four-tier system on income earned by CRT

CRT Not Subject to 3.8% Surtax

- Annuity and unitrust distributions may be net investment income to non-charitable beneficiary
- CRT income beneficiaries are subject to 3.8% surtax to extent distributions are considered NII
- Prop. Reg. 1.1411-3(b)3



Charitable Remainder Trust

Only NII realized by CRT after December 31, 2012 Included in CRT's NII

- Subject to 3.8% surtax when distributed to CRT income beneficiaries
- Any NII realized by CRT in taxable year prior to January 1, 2013 never subject to 3.8% surtax regardless of when considered distributed to non-charitable beneficiaries
- Prop. Reg. 1.1411-3(c)(2)(iii)

If More Than One Income Beneficiary

- Reportable NII apportioned between beneficiaries “based on respective shares of total annuity or unitrust amount paid by CRT for that taxable year”
- Prop. Reg. 1.1411-(c)(2)(ii)



Charitable Remainder Trust

Four-tier Structure

- IRS considered alternative methods for integrating 3.8% surtax into normal four-tier structure
- Concluded that would be administratively too complicated

IRS Adopted Simplified Method

Amount Includable in Beneficiary's NII (i.e., Amount Subject to 3.8% Surtax) **Lesser of**

- Total amount distributed for year
- *Current and accumulated NII* of trust
- Prop. Reg. 1.1411-3(c)(2)(i)



Charitable Remainder Trust

Accumulated NII

- Total amount of NII received by CRT for all taxable years after December 31, 2012
 - Less total amount of net investment income distributed for all prior taxable years of trust that begin after December 31, 2012
 - Note: accumulated net investment income will have to be tracked
- Prop. Reg. 1.1411-3(c)(2)(iii)

NII Realized by Trust before January 1, 2013

- Not includible in accumulated NII
- Not subject to 3.8% surtax even if distributed many years later



Charitable Remainder Trust

Four-tier System

- Amount of NII reported to beneficiary is separate and distinct from determination of tax character of CRT distribution under four-tier structure
- See preamble to Prop. Reg. 1.1411 at ¶4.B.iv.
- Current and accumulated NII is distributed in different sequence than income accumulated under four-tier system

Current and Accumulated NII is Deemed Distributed before Amounts That Are Not Items of NII for Purposes of §1411

- Notwithstanding, four-tier system otherwise applicable in determining taxation of CRT distributions



Charitable Remainder Trust—Example 1

Tier Income	2012	2013
Interest Income	\$2,500	\$22,000
Short-term Cap Gain	\$750	\$0
Long-term Cap Gain	\$500,000	\$44,000

2013 Distribution: \$50,000

Charitable Remainder Trust—Example 1

Tier Income	2012	2013
Interest Income	\$2,500	\$22,000
Short-term Cap Gain	\$750	\$0
Long-term Cap Gain	\$500,000	\$44,000

	Income under Tier System	Current and Accumulated NII
Interest Income	\$24,500	\$22,000
Short-term Cap Gain	\$750	\$0
Long-term Cap Gain	<u>\$24,750</u>	<u>\$28,000</u>
TOTAL	\$50,000	\$50,000



Charitable Remainder Trust—Example 1

Considerations

- NII amount reportable by CRT beneficiary cannot exceed amount beneficiary receives as distribution
- Despite fact that under four-tier system \$2,500 of interest and \$750 of STCG were accumulated during years prior to 2013, all of amount distributed was subject to 3.8% surtax because 2013 NII exceeded amount distributed in 2013
- NII amount reported to CRT beneficiary is separate calculation from determination of tax character of CRT distributions under four-tier system



Charitable Remainder Trust—Example 2

Tier Income	2012	2013
Interest Income	\$2,500	\$22,000
Short-term Cap Gain	\$750	\$0
Long-term Cap Gain	\$500,000	\$15,000

	Income under Tier System	Current and Accumulated NII
Interest Income	\$24,500	\$22,000
Short-term Cap Gain	\$750	\$0
Long-term Cap Gain	<u>\$24,750</u>	<u>\$15,000</u>
TOTAL	\$50,000	\$37,000



Charitable Remainder Trust—Example 2

Considerations

- NII amount subject to 3.8% surtax beneficiary must report is \$37,000
 - Lesser of amount distributed (\$50,000)
 - Current and accumulated NII (\$37,000)
- \$13,000 of amount distributed from pre-2013 NII not subject to 3.8% surtax
- Tax preparer must maintain separate schedules for amount of current and accumulated income subject to four-tier system and amount of current and accumulated NII
 - They can be different



Charitable Remainder Trust—Planning

Give Appreciated Asset to CRT

Sell Appreciated Asset in CRT

- CRT exempt from income tax, including 3.8% surtax
- No gain recognized

Annuity or Unitrust Payments Carry out NII to Non-charitable Beneficiaries

Spreads NII Passed out to Beneficiary over Multiple Years

Subjects NII to Higher Thresholds Applicable to Individuals

Minimizes, or at Least Defers, 3.8% Surtax



Pooled Income Funds

Proposed Regulations

- Pooled income funds are subject to 3.8% tax
- Otherwise silent and give no guidance



Pooled Income Funds

Distributes All Income to Fund's Income Beneficiaries

- Not subject to tax on fund's income but individual fund beneficiaries may be subject to 3.8% surtax

Capital Gains Never Paid to Beneficiaries

- Beneficiaries are not potentially subject to 3.8% surtax on capital gains

LTCG Not Taxable to Pooled Income Fund under Normal Rules

- Permanently set aside for charity so should not be subject to 3.8% surtax at fund or beneficiary level

STCG Are Taxable to Fund under Normal Rules

- **Q:** Are STCG in excess of surtax threshold (\$11,950 for 2013) subject to 3.8% surtax at fund level?
- **A:** Should not as STCG are also permanently set aside for charity
- Broad language of statute seems to subject STCG to 3.8% surtax
- Until Treasury gives guidance, we don't know if STCG are subject to 3.8% surtax



Charitable Lead Trusts

Non-grantor CLT

- NII in excess of amount distributed to charitable lead beneficiary and threshold amount (\$11,950 in 2013) subject to 3.8% surtax
- Non-grantor CLT allowed deduction for portion of NII allocated to amounts allowed as charitable deduction under §642(c)
- §642(c) deduction allowable to CLT reduces CLT's undistributed NII and shifts NII into hands of tax-exempt beneficiary not subject to 3.8% surtax



Charitable Lead Trusts

Grantor CLT

- Grantor is taxable on all trust income and capital gains even though they may be paid to charity
- CLT is not subject to 3.8% surtax because all income and gains flow through and are taxed to grantor
- Grantor will be subject to 3.8% surtax on income and gains earned by CLT if that income plus grantor's other NII exceed threshold applicable to grantor
- Grantor CLT not particularly useful in planning for 3.8% surtax



Charitable Gift Annuity

Charitable Gift Annuity

- Income on funds held by charity for gift annuity program not taxable unless they violate §514(c)(5) (relating to CGA and acquisition indebtedness) and §501(m) (relating to commercial insurance)
- Annuity payments (in excess of excludible amounts which are deemed return of principal) are NII to annuitant
- Any capital gain triggered by transfer of appreciated assets for CGA as determined under bargain sale rules is NII to donor
- CGA allows annuity payments and recognition of gain to be spread out over multiple years and subject to higher thresholds applicable to individuals and may minimize, or at least defer, the 3.8% surtax



CRAT vs. CGA

CGA Favorable

- Same charitable deduction available for CGA and CRT
- CGA not subject to 5% exhaustion test
- CGA not subject to onerous governing instrument and administration requirements of CRAT

CRAT Favorable

- Where there are doubts concerning charity's ability to make annuity payments
- CGA for term of years or for more than two lives are not permitted whereas they are for CRAT



Charitable Planning

Charitable Planning

- Outright charitable contributions of NII producing property to §501(c)(3) organization will shift NII attributable to property and charity thereby exempting NII from 3.8% surtax
- Provides another reason to “give away the gain”
- Donors wishing to retain control over charitable contributions (rather than making an unrestricted gift) can make contribution to private foundation or donor-advised fund of a public charity of which the donor is advisor



THANK YOU!

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