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Rapid Ascent of IRS Discount Rate Creates Opportunities

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In February, the IRS discount rate was 1.6%. In December, it is up to 5.2%, more than triple what it was just ten months ago. This dramatic change coincides with a similar escalation of interest rates in the U.S. generally, as well as increased nervousness over whether the rapid rise in interest rates might soon tip the economy into a recession.

Don't freak out over the swift shift in economic conditions. View it as an opportunity. This is a great time to renew contact with your donors and educate them about gift plans they might want to consider in this new economic reality.

Gift Annuities More Attractive to Many

Charitable gift annuities (CGAs) appeal to donors looking for a dependable source of steady income who also want to make a gift. This is especially true in times of uncertainty about the future, such as current fears of an impending recession.

In addition to providing a reassuring source of steady income, CGAs have become more attractive in two ways because of the recent increase in interest rates.

First, the American Council on Gift Annuities (ACGA) has responded by raising its suggested maximum annuity rates twice in six months. It raised its rates 0.4% - 0.6%, effective July 1, 2022, and will raise them again by a similar amount, effective January 1, 2023. For example, the ACGA rate for two 75-year-olds was 4.6% in February 2022 and will be 5.8% in January 2023.

Second, the deduction available for funding a CGA has skyrocketed. For example, in February 2022, our two 75-year-olds would have been offered a 4.6% CGA and earned a deduction of $40,106 for a $100,000 CGA. The deduction available to the same 75-year-olds funding the same 4.6% CGA in January 2023 will be $54,139. Even paying them January's new ACGA rate of 5.8%, they will earn a $42,176 deduction. That is, their deduction will have increased over $2,000 despite receiving $1,200 more each year for life. That's great news for itemizers!

There is a downside for CGAs, though. The taxable portion of the annuity payments has increased. In our example, it was just $948 out of $4,600 in February 2022. It will be $2,274 out of $5,800 in January 2023. For non-itemizers, in particular, the increased taxable portion will not be offset by any tax savings from an increased tax deduction.

CRATs Are Viable Again

Charitable remainder annuity trusts (CRATs) have been moribund for over a decade. With the IRS discount rate well below 5.0% since 2009, beneficiaries typically had to be in their 70s or older for a CRAT to pass the so-called 5% probability of exhaustion test. CRATs that failed this test would lose their tax deduction and tax-exempt status. That eliminated many potential CRAT donors right off the bat. In addition, even CRATs that passed the 5% test earned a much lower deduction than a comparable charitable remainder unitrust (CRUT). Given the choice, most donors chose a CRUT.

For example, a $1 million 5% CRAT with two 76-year-old beneficiaries in January 2022, when the IRS discount rate was 1.6%, just passed the 5% test and earned a deduction of $380,060. A similar CRUT earned a deduction of $507,710. Fast forward to December 2022, when the IRS discount rate is 5.2%: the same CRAT would earn a much higher $518,010 deduction while the CRUT deduction has only inched up to $514,870.

An IRS discount rate above 5.0% has given the CRAT new life. Using December's 5.2% IRS discount rate, a 5% CRAT won't fail the 5% test regardless of the beneficiary ages. It is also far less likely to fail the 10% deduction requirement. In fact, the donor's deduction will be slightly higher than it would be for a comparable 5% CRUT, rather than substantially lower. Further increases in the IRS discount rate will favor the deduction for a CRAT over a CRUT even more.

For donors interested in fixed income and contemplating a gift of sufficient size (typically, $250,000 or more), the CRAT is worth considering again. While a CGA can also provide fixed payments for life, a CRAT offers more flexibility. A CGA is limited to one or two annuitants, while a CRAT can have more than two income beneficiaries. A CGA must make payments for life, while a CRAT can make payments for a fixed term of up to 20 years or for a combination of fixed term and lives. A CGA donor has no control over how the CGA is administered or invested, while a CRAT donor can name the trustee who oversees how the CRAT is administered and invested.

Just because the CRAT has new life doesn't mean that the CRUT is now dead. The CRUT still works well for donors who want payments with the potential to increase over time, the option to add to their trust, or would find a net income or flip provision useful.

CLATs and RLEs Less Attractive Now

The increase in the IRS discount rate has made two planned gifts less appealing. The deduction available for funding a charitable lead annuity trust (CLAT) or retained life estate (RLE) has plummeted. For example, a 20-year $1,000,000 CLAT could earn a $1,000,000 deduction using January 2022's 1.6% IRS discount rate by paying $58,822 to charity each year. That same trust using December 2022's 5.2% IRS discount rate will earn a $720,780 deduction, a decrease of nearly $280,000. The deduction for an RLE has experienced a decline of similar magnitude. These gift plans can still work, but CLAT and RLE donors need substantially more charitable motivation than they did a year ago.

Spread the Word

The tripling of the IRS discount rate this year has significantly affected the deduction available for gifts that pay an annuity. CGAs should now be more attractive to many donors, especially those who itemize. CRATs may have new life after years in the wilderness. At the same time, CLATs and RLEs have become less attractive. All these changes give you good reasons to get in contact with your donors to update an existing proposal or discuss a new opportunity. Consider a CGA mailing touting its expanded benefits or an article about CRATs for your next newsletter. Change is good. Take advantage of it!