Turning a Tax Bill into Lifetime Income

By Alec Prinze AAMS®
Wealth Advisor, RJFS

Your top stock holding is your largest position, and more than likely is also your employer. Alerts are set on your stock app for any significant movement in the market. Your net worth swings up and down by the tens of thousands. If this sounds like you, then chances are you're a highly compensated employee for a publicly traded company OR you inherited a large stock position that's accumulated a lot of gains. Either way, the problem is the same: you've got a massive amount of your net worth in one single stock, and you're staring down the barrel of a massive capital gains tax bill.

What can you do? Well, that depends. There's plenty of strategies from Exchange Funds to Variable Prepaid Forwards to name a few. This case study, however, is focused on one strategy that isn't widely discussed: a New Pooled Income Fund (NPIF).

So what is a New Pooled Income Fund? It's a Split-Interest Gifting strategy where affluent individuals such as yourself "split" their interest in a sum of money between Donors (which can be themselves or a family member) and a Charitable entity. Sound complicated? That's because it is, but I'll break it down to help you understand.

The basics are this: You donate a sum or an asset to a charitable vehicle and in turn you may get a charitable deduction upfront AND receive the income generated off your donation. The designated charity will get a "remainder" in the distant future.

One key point is that you can accept a lower charitable deduction up front in exchange for lengthening the lifetime income.

If you had a younger person you wanted to designate as an income beneficiary, their age could be used in the Remainder Interest calculations found in IRS Actuarial Valuations Version 3A, resulting in income being paid out for a longer period and delaying the charity from receiving the remainder interest.

Let's get into the weeds on New Pooled Income Funds. A Charitable Entity such as a university or a supporting organization will utilize an asset manager to manage your donation with the objective of generating income for you, while preserving the principal value (Initial donation) for the selected charity.

The Charitable Entity will form a NPIF. Once formed, the donation will be invested with the objective of maximizing income while preserving the principal. The donor can name themselves, their children, or even a charity as the income beneficiary. Upon the death of the last income beneficiary, the remaining assets will be distributed to either the designated charity or a Donor-Advised Fund.

Earlier we mentioned assets could be donated. Now you may wonder what assets qualify for donation. That depends on the Charitable Entity. Some will only permit marketable securities (except for Municipal Bonds) and others will allow Real Estate (at an extra cost). Historically, they like taking Highly Appreciated Assets and donate them to a NPIF.

Why would you do this: This strategy could make sense if:

1. You are charitably inclined and want to establish a legacy of giving.
2. You own a Highly Appreciated Asset and want to be tax efficient in liquidating it.
3. You have a need for income.
4. You want to convert a tax liability into lifetime income.

Pros and Cons: As with any legal vehicle, there are pros and cons. Lets dive into them:

Pros

- Contributions to a New Pooled Income Fund (NPIF) may result in a charitable tax deduction for the donor that can be claimed immediately.
- NPIFs can reduce estate taxes and remove the assets from your taxable estate.
- Assets in a NPIF can avoid probate in the event the estate goes into probate.
- When appreciated assets, like a low basis stock, are donated to a NPIF, the donor does not incur capital gains taxes on the sale of those assets within the fund.
- The structure of beneficiary designations in charitable NPIFs is quite flexible.

Cons

- The remainder assets in a NPIF are an irrevocable gift, meaning it can't be reversed.
- Recipients of the NPIF income, unless they are a tax-exempt nonprofit, pay standard income taxes on these payments.
- If recipients of the income include individuals who are not the donor, gift taxes may be assessed.
- The tax benefits and tax liability applied to assets held in and income distributed from a charitable NPIF vary based on the details of the fund and those specified in the instrument of transfer.
- The types of contributions that can be made to a NPIF are limited both by the specific requirements of individual funds and IRS regulations.
    - For example, the IRS prohibits the donation of tax-exempt securities to PIFs.

Disclaimers: You should consult your Tax, Legal, and Investment counsel to see if a New Pooled Income Fund is right for you.

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Contributors
Gill, A.K. (MBA, CPA, CEP)

References

IRS Actuarial Valuations Version 3A; *Department of the Treasury Internal Revenue Service Publication 1457 (5-2009) Catalog Number 63854M*

- Actuarial Tables location: *http://www.irs.gov/retirement/article/0,,id=206601,00.html*

Maximizing Split-Interest Charitable Deductions with New Pooled Income Funds Over CRTs

- Website: *https://www.kitces.com/blog/charitable-pooled-income-fund-new-npif-tax-deduction-7520-interest-rate-crt-comparison/*