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EXHIBIT 3

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HB SB108

Montana Department of Revenue



Steve Bullock
Governor

To: Sen. Bruce Tutvedt, Chair - Senate Tax Committee
From: Dan Dodds, Senior Economist
Date: January 20, 2013
Subject: Mechanics of the Charitable Endowment Credit

This memo shows the calculation of the charitable endowment credit for a planned gift by a hypothetical middle-income couple and the effect on their state and federal income taxes.

The taxpayers in this example are a couple in their early 60s. They are planning to retire soon and are setting up their finances. They also are thinking about their long-term legacy, including gifts to charity. The fundraiser for their favorite charity suggests setting up a planned gift as a way to provide retirement income while making a donation to the charity's endowment fund.

The couple places \$15,000 in a charitable remainder annuity trust. The trust will pay them \$1,225 per year for ten years. After ten years, about half of the original principal will be left, and it will go to the charity. Table 1, below, shows the trust's earnings, assuming a 4% rate of return, the distributions to the donors, and the balance at the end of each year.

Donation to Montana Charitable Endowment Using Charitable Remainder Annuity Trust

	Amount Deposited in Trust	Trust Fund Earnings @ 4%	Distribution to Donors	Ending Balance in Trust	Distribution to Charitable Endowment
2012	\$15,000.00			\$15,000.00	
2013		\$600.00	\$1,225.00	\$14,375.00	
2014		\$575.00	\$1,225.00	\$13,725.00	
2015		\$549.00	\$1,225.00	\$13,049.00	
2016		\$521.96	\$1,225.00	\$12,345.96	
2017		\$493.84	\$1,225.00	\$11,614.80	
2018		\$464.59	\$1,225.00	\$10,854.39	
2019		\$434.18	\$1,225.00	\$10,063.57	
2020		\$402.54	\$1,225.00	\$9,241.11	
2021		\$369.64	\$1,225.00	\$8,385.75	
2022		\$335.43	\$1,225.00	\$7,496.18	\$7,496.18
2012 Present Value @ 4% of Distribution to Charitable Endowment in 2022					\$5,064.15

The amount the couple can use to claim the credit or an itemized deduction is the present value of the amount the charity will receive in 2022. This is \$7,496.18 discounted for 10 years, or \$5,064,15.

Table 2 shows the assumptions used in calculating the couple's taxes. The couple's combined income is \$60,000, and they can claim two exemptions. They can claim a state itemized deduction for \$5,200 of federal taxes withheld, and can claim a federal itemized deduction for \$2,300 in state taxes withheld. They have \$5,000 of other itemized deductions. The calculations are shown in Tables 3 through 5 and the attached tax returns.

Table 2. Assumptions

Income (Shown as Wages and Salaries for Simplicity)	\$60,000
Personal Exemptions	2
Itemized Deduction Items	
Federal Income Tax Withheld in 2012	\$5,200
Montana Income Tax Withheld in 2012	\$2,300
Real Estate Taxes	\$2,500
Personal Property Taxes (Vehicle Licenses)	\$500
Charitable Contributions (Not Credit Eligible)	\$2,000
Present Value of Residual to Charitable Endowment	\$5,064

Table 3 shows the calculation of the couple's state and federal income taxes if they had not made the donation. It shows both the total of itemized deductions and the standard deduction and then uses the larger of the two in calculating taxable income.

Table 3. Tax Return Calculations Without Contribution to Charitable Endowment

	Montana		Federal
Total Income	\$60,000	Total Income	\$60,000
Deductions		Deductions	
Itemized	\$10,200	Itemized	\$7,300
Standard	\$8,400	Standard	\$11,900
Deduction Used	\$10,200	Deduction Used	\$11,900
Exemptions	<u>\$4,480</u>	Exemptions	<u>\$7,600</u>
Taxable Income	\$45,320	Taxable Income	\$40,500
Tax	\$2,605	Tax	\$5,205

Table 4, on the next page, shows the calculation of the couple's taxes if they make the contribution and take state and federal itemized deductions. This is what they would do if the credit were not available.

**Table 4. Tax Return Calculations With State and Federal Itemized Deductions
for Contribution to Charitable Endowment**

Montana			Federal		
Total Income		\$60,000	Total Income		\$60,000
Deductions			Deductions		
Itemized	\$15,264		Itemized	\$12,364	
Standard	\$8,400		Standard	\$11,900	
Deduction Used	\$15,264		Deduction Used	\$12,364	
Exemptions		<u>\$4,480</u>	Exemptions		<u>\$7,600</u>
Taxable Income		\$40,256	Taxable Income		\$40,036
Tax		\$2,256	Tax		\$5,135

The deductions reduce both state and federal tax liability.

Table 5 shows the calculation of the couple's taxes if they take the charitable endowment credit and the federal itemized deduction.

**Table 5. Tax Return Calculations With State Credit
and Federal Itemized Deduction for Contribution to Charitable Endowment**

Montana			Federal		
Total Income		\$60,000	Total Income		\$60,000
Deductions			Deductions		
Itemized	\$10,200		Itemized	\$12,364	
Standard	\$8,400		Standard	\$11,900	
Deduction Used	\$10,200		Deduction Used	\$12,364	
Exemptions		<u>\$4,480</u>	Exemptions		<u>\$7,600</u>
Taxable Income		\$45,320	Taxable Income		\$40,036
Tax		\$2,605	Tax		\$5,135
Credit		<u>\$2,026</u>			
Tax After Credit		\$579			

Their federal taxes are the same as in Table 4. Their state taxes before the credit are the same as in Table 3, since taxpayers are not allowed to take both the credit and an itemized deduction for the same amount. The credit is 40% of the present value of the \$7,496 that ultimately goes to the charitable endowment.

Table 6 shows the net impacts of the credit on the couple's taxes.

Table 6. Net Tax Impact of Credit

Couple Takes State and Federal Deductions	
2012 Montana Income Tax	\$2,256
2012 Federal Income Tax	\$5,135
Couple Takes State Credit and Federal Deduction	
2012 Montana Income Tax	\$579
2012 Federal Income Tax	\$5,135
Difference in 2012 Taxes	
Montana	-\$1,676
Federal	\$0

For this couple, there is no change in their 2012 federal taxes. Their 2012 Montana taxes are reduced by the difference between the credit and the tax effect of taking the deduction instead, \$1,676.

Taking the credit for 2012 will not affect this couple's taxes in 2013 or later years. This is because they took the standard deduction on their federal tax return. If they had had enough deductions to itemize on their federal return, they would have to report the state refund they get because of the credit as income for their 2013 federal taxes. This would result in higher 2013 federal taxes, which could feed back to the couple's Montana taxes through the state deduction for federal taxes. Higher income taxpayers who are working with a financial planner are likely to reduce tax payments in the year they make a donation and to take the interaction of state and federal deductions into account.