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THE Good Advisor

Plotting a Course: The Best Way to Stay on Track

Not unlike modern travelers, ancient wanderers began journeys by plotting a course. For ancient voyagers, this meant charting the stars, following the rivers or using terrestrial landmarks. For us, the newest generation of travelers, navigation simply means using a GPS[1]—a wonder of technology that accesses orbiting satellites to pinpoint where we are. This remarkable system not only locates us, it provides turn-by-turn directions from a starting point to virtually any place on earth.

Understanding where we are and where we are going is also critical for a sound financial journey. As we move through life, we face a number of decisions. Picking the right path leads to fulfillment, while making the wrong choice can lead to disastrous results. Since all financial journeys are unique, with any number of choices and complexities, wouldn't it be nice to have a financial GPS?

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- **The Basic Documents of Estate Planning**
- **Hazards in Charitable Planning**

Solid Footing for the Journey: The Basic Documents of Estate Planning

A solid start in the right direction is the best preparation for a successful journey. For financial journeys, this involves taking care of estate planning basics. Let's take a closer look at a planning cornerstone (a will) and an important planning option (a trust).

The Will

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Purpose of a Will: A Roadmap for the Estate

A will can settle a number of important estate matters. It lets an individual:

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Of course, a will's primary purpose is distributing assets. To do this, the testator makes bequests of specific property (stock, money, jewelry, a car, etc.) to specific individuals. These gifts are often straightforward, but can get complicated for assets that are difficult to divide or hold significant sentimental value for many family members. The testator may also wish to leave a gift to charity—perhaps a favorite cause, an alma mater, or a church. A "charitable bequest" is a meaningful way to make a difference or even honor a loved one.

Trusts

A will is a vital starting point for most estate plans, but is certainly not the only element in the estate planning map. If we think of the will as a basic roadmap for an estate, a trust would be a much more detailed atlas. For a more complex financial journey, this additional detail and control can be vital.

As you know, a trust is a legal entity created by an individual (the "grantor" of the trust). The grantor transfers property into the trust, and a trustee manages that property for the benefit of the beneficiaries. Unlike a will, which is entered into the probate court, a trust created during the grantor's life is not a public document. Testamentary trusts created under a will obviously lose that privacy, since they are part of the probate record.

A trust provides the grantor with a degree of control that is not possible with a simple will—in particular, the ability to control and distribute assets after death through the trust terms. For example, "spendthrift" provisions or the release of assets to beneficiaries over a period of years or decades is particularly beneficial when the grantor is concerned that a family member would wastefully spend an outright inheritance.[2]

Trusts can be revocable or irrevocable. A revocable trust (also known as a living trust, revocable living trust, or inter vivos trust) lets the grantor, at any point during life, change the terms, add or remove property, or even (as the name implies) revoke the trust. On the other hand, an irrevocable trust lacks this flexibility—once it is created, the grantor cannot change it. In fact, the grantor surrenders all ownership rights to any property that is placed in an irrevocable trust.

Trusts are also useful in charitable giving, since they help the grantor accomplish estate planning goals while benefiting a selected charity. Let's take a closer look at two charitable trusts—the charitable remainder trust (CRT) and the charitable lead trust (CLT).

Charitable Remainder Trusts

A charitable remainder trust (CRT) lets a grantor provide income for a spouse or other beneficiary while making a substantial charitable donation. It is an irrevocable trust that pays one or more noncharitable beneficiaries an income during the trust term, then distributes the remainder to charitable remaindermen (at least one of which must be a qualified charity).

When creating the CRT, the grantor must identify:

- The beneficiary (or beneficiaries) who will receive the trust distributions
- The length of the trust term (the life or lives of the individuals, or a period of up to 20 years)[3]
- The charitable remaindermen who will receive the assets remaining at the end of the trust term[4]

The grantor must also identify the amount to be paid to the beneficiary. This amount is flexible within stated parameters and depends on the type of charitable remainder trust being used:[5]

- A **charitable reminder annuity trust (CRAT)** pays out a fixed percentage (at least 5% but not more than 50%) of the trust's initial value
- A **charitable remainder unitrust (CRUT)** pays out a fixed percentage (at least 5% but not more than 50%) of the trust's annually revalued assets

The value of the charitable remainder for both CRAT and CRUT must be 10% or more of the initial value of the property transferred to the trust.[6]

Some grantors choose to give through a CRT for the income tax benefit—an immediate income tax charitable deduction based on the present value of the charity's remainder interest.[7] This deduction is calculated with a formula using the percentage payout stated in the trust, the life expectancy of the income beneficiary (or beneficiaries), and the interest assumption reflected by the AFR (Applicable Federal Rate) for the month of the gift or either of the two preceding months.[8] It is important to note that the selection of a higher AFR can allow for a greater income tax charitable deduction. Furthermore, a grantor who donates appreciated property to the CRT does not incur capital gains taxes on the transfer and the trust can then sell the appreciated property.

Avoiding the Pitfalls: Hazards in Charitable Planning

While the wise traveler uses a GPS, that doesn't preclude unexpected hazards or detours. Understanding how to navigate away from these hazards is a critical part of the financial journey. When charitable gifts are part of an estate plan, an advisor who can warn of possible "pitfalls" provides an important service to both the client and the charity.

While clients are compelled to give out of a sense of commitment and generosity, most are also keenly interested in the preferential tax treatment that goes along with a charitable transfer. With that in mind, advisors are much better off helping to structure a client's gift to meet the requirements of the Internal Revenue Code from the beginning than arriving as a rescue service after the tax damage has already been done. Let's look at a few obvious pitfalls that can impact the tax treatment of a charitable gift.

The Mother of All Potholes: Gifts Made Subject to a Condition

A client making a generous gift to a charity may find it reasonable to place a condition on the gift. The IRS has a different perspective. Treasury Regulation 1.170A-1(e)[9] discusses "Transfers subject to a condition or power."

For the concerned client, the key takeaway in this regulation is that a gift made conditional on a preceding act or event cannot qualify for a charitable deduction unless the condition that would preclude the gift "is so remote as to be negligible."[10] But what does that mean, exactly? The IRS provides an answer by way of illustration in the same regulation:

For example, "A" transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible, A is entitled to a deduction under section 170 for his charitable contribution.[11]

Defining "so remote as to be negligible" is a continuing question. In a charitable conservation easement case, Graev v. Commissioner, the U.S. Tax Court noted:

In prior cases, we have defined "so remote as to be negligible" as "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction." 885 *Inv. Co. v. Commissioner*, 95 T.C. 156, 161 (1990) (quoting *United States v. Dean*, 224 F.2d 26, 29 (1st Cir. 1955)). Stated differently, it is "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance." *Briggs v. Commissioner*, 72 T.C. at 657.[12]

Not Letting Go of the Wheel: Partial Interest Gifts

While the federal tax laws are generally against conditions on charitable gifts, the possibility of a client retaining a partial interest in a gift has a more open road. To take a deduction, the donor must transfer the entire interest in a gift to a qualified charity. The gift must be irrevocable and the donor may not continue to control donated property. A gift of a partial interest generally does not qualify for a deduction.[13] However, IRC Section 170(f)(3)(B) identifies three exceptions to the partial interest rule. A deduction is allowed for a contribution of:

- A remainder interest in a personal residence or farm
- An undivided interest
- A qualified conservation contribution[14]

Reaching the Destination

There is that moment near the end of a long trip when the weariness of travel suddenly melts away. The many miles of road no longer seem so disagreeable when the joy of finishing the journey is at hand. When you help clients prepare well and make good decisions along the way, you can share in the excitement as they reach their financial destinations. After all, a well-executed financial journey can be truly fulfilling—for the client, for the family members and for any charitable beneficiaries.

ENDNOTES

1 Beyond Discovery "The Global Positioning System" http://www.nasonline.org/publications/beyond-discovery/

2 Trusts can be designed to release funds at intervals, such as when the beneficiary reaches age 25 or 30 or 40, or with "HEMS" powers (Health, Education, Maintenance, Support).

3 IRC Sec. 664(d)(1)(A), 664(d)(2)(A).

4 Ibid.

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6 IRC Sec. 664(d)(1)(D), 664(d)(2)(D).

7 IRC §170.

8 IRC §7520.

9 Treas. Reg. §1.170A-1(e).

10 See also Treas. Reg. §20.2055-2(b), and Treas. Reg. §25.2522(a)-2(b).

11 Treas. Reg. §1.170A-1(e).

12 Graev v. Commissioner, 140 T.C. No. 17 (June 24, 2013).

13 IRC Section 170(f).

14 IRC §170(h); Treas. Reg. §1.170A-14(a).

Access more information now!

An electronic copy of our campanion booklet with a more in-depth treatment of basic estate planning documents and charitable giving hazards as well as additional discussions including intestacy, the new revenue procedure affecting CRATs, charitable lead trusts, and finding IRS guidance on both CRTs and CLTs may be accessed in the Professional Advisor section of our webite at **www.catholicfoundation.com.**

You can download this PDF and store it on your PC or tablet for easy access.

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PRACTICE TIP: Reviewing Charitable Bequests During Drafting

Many estate planning professionals proactively ask clients about charitable intentions as part of the will preparation process. Due to the often-stressful nature of writing a will, clients sometimes focus intently on the distribution of assets and forget (or do not know) that they can include a charitable bequest. Most clients are happy to be reminded (or to learn) that this giving option exists.

Be sure to contact the development staff of the selected charity for specific bequest language to be included in the client's will.

The IRA Charitable Rollover

As anyone who drives will testify, it's common to see other drivers texting, talking on the phone, or multitasking in any number of ways. Distracted drivers are not only more likely to drive right past their exit, but they consistently put themselves and others in danger. Inattention in estate planning can have similarly disastrous results. Nowhere is this more evident than when we look at individuals who fail to make a will.

When a person dies without a will, state law steps in and provides directions for the distribution of the estate. Intestate succession statutes specify the distribution of assets based on family relationships only—not usually the distribution the decedent would have chosen, since these laws don't consider any special circumstances, friends, charities, and so forth. In addition, no consideration is given to minimizing taxes or estate costs, putting an additional price on the failure to plan.

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The Five Basic Elements of a Trust

1. **Grantor** – The individual who sets up the trust and transfers assets to a third party.
2. **Trustee** – An individual (or corporation or bank) who keeps legal title, possession and control over the trust property.
3. **Trust property** – The assets (or "corpus") may include almost anything capable of being legally owned, such as real or personal property, or a contract right such as a life insurance policy.
4. **Beneficiaries** – The recipients of the trust income and corpus.
5. **Trust terms** – The instructions detailing the trustee's duties and the eventual distribution of assets.

A trust provides the grantor with a degree of control that is not possible with a simple will—in particular, the ability to control and distribute assets after death through the trust terms. For example, "spendthrift" provisions or the release of assets to beneficiaries over a period of years or decades is particularly beneficial when the grantor is concerned that a family member would wastefully spend an outright inheritance.[2]

Trusts can be revocable or irrevocable. A revocable trust (also known as a living trust, revocable living trust, or inter vivos trust) lets the grantor, at any point during life, change the terms, add or remove property, or even (as the name implies) revoke the trust. On the other hand, an irrevocable trust lacks this flexibility—once it is created, the grantor cannot change it. In fact, the grantor surrenders all ownership rights to any property that is placed in an irrevocable trust.

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The value of the charitable remainder for both CRAT and CRUT must be 10% or more of the initial value of the property transferred to the trust.[6]

PRACTICE TIP: Avoiding the Probability-of-Exhaustion Test in a CRAT

Grantors have always had to be careful to ensure that the CRAT did not fail the probability-of-exhaustion test.[7] This test requires that there may not be greater than a 5% chance that the payments to the beneficiaries will exhaust the trust. The calculation for this test is based on two items–the AFR in §7520 and the mortality table published by the IRS (Table 2000CM). In periods with a very low AFR (as we've experienced recently), it is difficult for a CRAT to pass this test.

To help with this problem, the IRS issued a new revenue procedure [Rev. Proc. 2016-42] on August 8, 2016. This allows a CRAT to avoid the probability-of-exhaustion test by including this exact language:

"The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus, when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to [1/(1+i)]t, where t is the time from inception of the trust to the date of the annuity payment, expressed in years and fractions of a year, and i is the interest rate determined by the Internal Revenue Service for purposes of section 7520 of the Internal Revenue Code of 1986, as amended (section 7520 rate), that was used to determine the value of the charitable remainder at the inception of the trust. The section 7520 rate used to determine the value of the value of the charitable remainder at the inception of the trust is the section 7520 rate in effect for [insert the month and year], which is [insert the applicable section 7520 rate]."

Some grantors choose to give through a CRT for the income tax benefit—an immediate income tax charitable deduction based on the present value of the charity's remainder interest.[8] This deduction is calculated with a formula using the percentage payout stated in the trust, the life expectancy of the income beneficiary (or beneficiaries), and the interest assumption reflected by the AFR (Applicable Federal Rate) for the month of the gift or either of the two preceding months.[9] It is important to note that the selection of a higher AFR can allow for a greater income tax charitable deduction. Furthermore, a grantor who donates appreciated property to the CRT does not incur capital gains taxes on the transfer and the trust can then sell the appreciated property.

Charitable Lead Trusts

A charitable lead trust (CLT) is essentially the opposite of a CRT—the trust pays an annual income to a qualified charitable organization for a specified period of years, then passes the remaining principal back to the grantor or to named noncharitable beneficiaries (often the grantor's children or grandchildren).[10] The annual payment to charity must be either a specified fixed dollar annuity payment (a CLAT) or a specified percentage of the annually revalued trust assets (a CLUT).[11] In general, the trust may not make payments other than these income payments to charity until the trust terminates.

The CLT makes a gift of income to a charitable institution before passing the property to the named beneficiaries. Because the value of the income interest is tax deductible for federal estate tax purposes, individuals often use a CLT to reduce taxes while ultimately passing ownership to family members or other beneficiaries.[12] Plus, any appreciation in the value of the property that exceeds the value at the time it was included in the decedent's estate will pass to the heirs without additional transfer taxes when the CLT term expires. As a result, funding a CLT with assets expected to increase in value can be an important tax minimization technique.

The grantor may choose to set up a CLT during life (inter vivos CLT) or at death (testamentary CLT), depending on the primary motive:

- The testamentary CLT offers transfer tax savings, with the important side benefit of passing a tax basis to beneficiaries (when the CLT ends) that is stepped-up to the estate tax value of the trust property.
- The inter vivos CLT offers current income tax savings, but can also produce transfer tax savings. The gift tax charitable deduction (for a qualified CLT) reduces the value of the gift to the noncharitable remaindermen in the case of a nongrantor CLT (but without the stepped-up basis).

Additional tax benefits include the following:

- The present value of any remaining charitable payments at the grantor's death is estate-tax deductible if the CLT is included in the grantor's gross estate.
- Any appreciation in the value of the trust principal after the trust is created escapes transfer tax entirely (unless the generation-skipping tax is triggered upon trust termination).

Planning with a CLT must include a consideration of the generation-skipping transfer (GST) tax (e.g., naming a grandchild as a noncharitable beneficiary). A testamentary CLUT can include a formula to control the value of the remainder interest so that the value equals the decedent's available GST tax exemption at death. However, the rules are different for a testamentary CLAT, which allocates the GST tax exemption at the time the trust expires, not at the time it is funded. And, the transfer to a testamentary CLAT does not qualify for the charitable deduction for GST tax purposes.

PRACTICE TIP: The IRS Offers Guidance

Advisors and attorneys can turn to the IRS for guidance in creating both CRTs and CLTs.

CRTs – The IRS published a series of sample CRAT forms [Rev. Proc. 2003-57 through Rev. Proc. 2003-60] and CRUT forms [Rev. Proc. 2005-56 through 2005-59].

CLTs – The IRS published a series of sample CLAT forms, including forms for testamentary trusts [Rev. Proc. 2007-46] and CLUT forms [Rev. Proc. 2008-46 through 2005-59].

The sample forms contain basic provisions, alternate provisions, and annotations.

Avoiding the Pitfalls: Hazards in Charitable Planning

While the wise traveler uses a GPS, that doesn't preclude unexpected hazards or detours. Understanding how to navigate away from these hazards is a critical part of the financial journey. When charitable gifts are part of an estate plan, an advisor who can warn of possible "pitfalls" provides an important service to both the client and the charity.

While clients are compelled to give out of a sense of commitment and generosity, most are also keenly interested in the preferential tax treatment that goes along with a charitable transfer. With that in mind, advisors are much better off helping to structure a client's gift to meet the requirements of the Internal Revenue Code from the beginning than arriving as a rescue service after the tax damage has already been done. Let's look at a few obvious pitfalls that can impact the tax treatment of a charitable gift.

The Mother of All Potholes: Gifts Made Subject to a Condition

A client making a generous gift to a charity may find it reasonable to place a condition on the gift. The IRS has a different perspective. Treasury Regulation 1.170A-1(e)[13] discusses "Transfers subject to a condition or power." This section states:

> If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable.

For the concerned client, the key takeaway in this regulation is that a gift made conditional on a preceding act or event cannot qualify for a charitable deduction unless the condition that would preclude the gift "is so remote as to be negligible."[14] But what does that mean, exactly? The IRS provides an answer by way of illustration in the same regulation:

> For example, "A" transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible, A is entitled to a deduction under section 170 for his charitable contribution.[15]

The IRS further discusses this issue in Revenue Ruling 2003-28 using a situation where a patent holder donated a patent to a university subject to a conditional reversion. The facts are as follows:

> Y contributes a patent to University subject to the condition that A, a faculty member of University and an expert in the technology covered by the patent, continue to be a faculty member of University during the remaining life of the patent. If A ceases to be a member of University's faculty before the patent expires, the patent will revert to Y. The patent will expire 15 years after the date Y contributes it to University.[16]

Citing §1.170A-1(e), the IRS said that "on the date of the contribution, the possibility that A will cease to be a member of the faculty before the expiration of the patent is not so remote as to be negligible. Therefore, no deduction is allowable under §170(a)." Defining "so remote as to be negligible" is a continuing question. In a charitable conservation easement case, Graev v. Commissioner, the U.S. Tax Court noted:

> In prior cases, we have defined "so remote as to be negligible" as "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction." 885 Inv. Co. v. Commissioner, 95 T.C. 156, 161 (1990) (quoting United States v. Dean, 224 F.2d 26, 29 (1st Cir. 1955)). Stated differently, it is "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance." Briggs v. Commissioner, 72 T.C. at 657.[17]

PRACTICE TIP: Consider Seeking a PLR

If the client is absolutely set on making the charitable gift subject to a condition, it may be prudent to seek a private letter ruling (PLR) on the proposed transaction before proceeding. Being proactive about the transaction would be much better than the client making the gift only to find out that the possibility of a tax deduction is a "dead end."

Not Letting Go of the Wheel: Partial Interest Gifts

While the federal tax laws are generally against conditions on charitable gifts, the possibility of a client retaining a partial interest in a gift has a more open road.

To take a deduction, the donor must transfer the entire interest in a gift to a qualified charity. The gift must be irrevocable and the donor may not continue to control donated property. A gift of a partial interest generally does not qualify for a deduction.[18] However, IRC Section 170(f)(3)(B) identifies three exceptions to the partial interest rule. A deduction is allowed for a contribution of:

1. **A Remainder Interest in a Personal Residence or Farm:** The donor (and spouse, if desired) makes a charitable gift of the remainder interest in a personal residence or farm while retaining a life estate in the property (i.e., full enjoyment of the property for life or a term of years).
2. **An Undivided Interest:** The donor makes a charitable contribution (not in trust) of an undivided portion of a donor's entire interest in property, which must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property. It must also extend over the entire term of the donor's interest in such property and in other property into which such property is converted.
3. **A Qualified Conservation Contribution:** The donor makes a contribution of real property with a perpetual conservation restriction that is enforceable by a qualified organization to meet conservation purposes.[19]

In addition to the partial interest gifts stated in §170(f), the IRS has taken the position that a donor's retention of insubstantial rights that do not interfere with the charity's interest in the property does not cause the gift to be termed a non-deductible partial interest. For example, in Revenue Ruling 75-66, the IRS ruled that a donor who makes a gift of land with the restriction that the donor be allowed to train his hunting dogs on the land is an insubstantial right.[20]

However, when the IRS determines that a donor's retained rights are not insubstantial, the gift will no longer be deductible. For example, if the donor retains:

- The right to vote shares of donated stock[21]
- Mineral rights believed to be viable in underlying contributed land[22]
- The right to cut timber on the contributed land[23]

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4 Ibid.

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6 IRC Sec. 664(d)(1)(D), 664(d)(2)(D).

7 Regulation 1.170A-1(e) and Rev. Proc. 70-452.

8 IRC §170.

9 IRC §7520.

10 Treas. Reg. §20.2055-2(e)(2)(vi)(a) and §20.2055-2(e)(2)(vii)(b).

11 Ibid.

12 IRC §2055(e)(2)(B).

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16 Rev. Ruling 2003-28.

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18 IRC Section 170(f).

19 IRC §170(h); Treas. Reg. §1.170A-14(a).

20 Rev. Rul. 75-66, 1975-1 CB 85. In this revenue ruling the taxpayer contributed land to the U.S. with the retained right to train his personal hunting dog on the trails extending over the entire tract. The IRS found that this use was "in accordance with the regulations of the Department of the Interior on such use, is not substantial enough to affect the deductibility of the property contributed." The contribution was deductible by the individual in the manner and to the extent provided by section 170 of the Code.

21 Rev. Rul. 81-282, 1981-2 CB 78.

22 Rev. Rul. 76-331, 1976-2 CB 52.

23 Rev. Rul. 76-253, 1976-2 CB 51.

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