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Volcanoes and CRTs: From Powerful Production to a Fulfilling Extinction

Volcanoes are one of the most breathtaking natural wonders on Earth. Amazing lava displays and dramatic volcanic landscapes provide a fascinating subject for scientists and unique destinations for travelers. Although volcanoes have become synonymous with force and power, that is only one phase of their exceptional "life cycle."

A volcano is "born" when the earth's tectonic plates shift to create an opening where magma flows through. The cooled magma forms a new crust. Further movement of the plates lets more magma escape, eventually building up the crust into a volcano's familiar shape. During a volcano's active eruption phase, which may last hundreds of years, the volcano continues to discharge lava and may erupt violently. After eruption, the volcano may fall dormant, releasing only small emissions. Eventually, the volcano may totally lose its magma source and become extinct. At extinction, the massive power of the volcano is spent, but the volcano's legacy of exceptionally rich soil remains to nourish flora and fauna for many centuries into the future.

While a charitable remainder trust (CRT) does not have the spectacular appeal of a volcano, it nonetheless shares other unique similarities. It is a powerful giving device that may be created when a charitably minded individual shifts assets around, freeing up funds for a significant charitable contribution. During its life, a CRT produces a regular income flow to the donor or other named beneficiaries. At the end of its life, the trust produces a meaningful charitable gift—a legacy that can nourish the charity for many years into the future.

In this issue of ***The Good Advisor*** we explore the basics of the charitable remainder trust.

Formation: Creating and Funding a CRT

Mt. Kilauea is the world's most active volcano. As Hawaii's youngest volcano,[1] Kilauea is in an "effusive" state, meaning it is covered by "young" lava deposits from the past 2,500 years. Lava continues to flow freely from the summit and rift zone vents (openings in the earth's surface that emit magma or gasses).[2] Although forming a charitable remainder trust is certainly not as remarkable as these dramatic lava flows, distributions from the trust can provide striking benefits to trust beneficiaries and exceptional funds to charity when the trust ends.

A charitable remainder trust (CRT) is an irrevocable trust that provides annual distributions to a non-charitable beneficiary for a specified period. The non-charitable beneficiary can be the donor or one or more individuals designated by the donor, and the payouts can last for a period of years (up to 20), for life, or for joint lives. At the conclusion of the payout period, the trust remainder interest is distributed to a qualified charity. As such, each donor's unique planning needs and proclivities influence the terms of the trust.

A CRT is a split-interest gift—a gift of a remainder interest to charity with a retained income interest (for the amounts the trust pays to the income beneficiary). To qualify as a split-interest trust (which generates an income tax deduction for the donor), a CRT must meet the criteria described under Section 664(d) of the Internal Revenue Code.[3] The transfer of the charitable interest qualifies for a charitable gift tax deduction in an amount equal to the present value of the remainder interest in the year the trust is created.[4]

Types of Charitable Remainder Trusts: CRATs and CRUTs

There are two types of charitable remainder trusts—the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT)[5] They both meet the definition of a CRT (namely, a split-interest gift), but the main difference lies in how the annual distribution amount is determined. A CRAT pays out a set amount (a fixed percentage of the initial value of the trust assets) while a CRUT pays out a specified percentage of the trust assets as revalued each year.[6]

Funding the Trust

Since the trust is required to make distributions at least annually, an illiquid asset that does not generate income may not be a good CRAT funding choice (unless sufficient cash is also part of the gift).[7] It is also important to note that additional contributions to the CRAT are not allowed after the initial contribution.[8]

While a CRAT usually requires a certain amount of liquidity in its trust assets, a CRUT has much more flexibility. The CRUT comes in four varieties:

- a straight or fixed-percentage unitrust
- a net-income (without make-up) unitrust
- a net-income with make-up unitrust (NIMCRUT)
- a "flip" unitrust

Capital Gains Tax

The CRT assumes the donor's adjusted cost basis for any asset contributed to the trust and also takes the donor's holding period for the asset into account. A donor could transfer a highly appreciated asset into the trust free of capital gains tax. Since the trust is tax exempt (unless it has any unrelated business taxable income under IRC §512), the trust can sell the property and realize the gain without being subject to capital gains tax.[9]

Income Beneficiaries

Both the CRAT and the CRUT require that the trust makes distributions to the named income beneficiaries.[10] The IRC also requires that at least one of the income beneficiaries must be a person other than a charity (referred to as an organization listed in IRC §170(c)). The named individual must be alive and ascertainable at the time the trust is created, unless the trust term is for a period of years.[11]

Activity and Eruptions: Trust Distributions and the Activities of the CRT

Rising above the city of Catania in Sicily, Mt. Etna is one the most active volcanos in Europe, with consistent eruptions since 2001. Although Mt. Etna's continuing lava flow provides a challenge to residents who live on or near the mountain, the volcano also brings income to residents, since Mt. Etna is a tourist destination and the rich volcanic soil is excellent for farming.[12]

CRTs also provide income through a stream of distributions that consistently flow from the trust to the named income beneficiary. But while lava is nearly impossible to control, the donor has significant control of the manner in which trust income is distributed.

Trust Distributions

The donor sets the payout rate for the CRT, but must follow the requirements found in the Internal Revenue Code. The payout rate must be at least 5% (but not more than 50%) of the initial value of the assets transferred to the trust, and the calculation for the proposed CRT at the given rate must provide at least a 10% remainder to charity.[13]

CRAT Payouts

The payout of a CRAT is fixed at the time the trust is created and never varies—not even if the trust fluctuates in value.[14] The payout may be an annuity percentage or some other amount that is fixed in the trust.

Prior to August 8, 2016, for a CRAT to qualify for the applicable tax deductions, the CRAT had to pass the 5% probability test (probability-of-exhaustion test).[15] This test required that the annuity amount could not be so large that there was a greater-than-5% probability that the corpus would be exhausted before the (last) noncharitable beneficiary dies, the trust terminates, and the charity receives its remainder. With the low interest rates over the last several years having a significant impact on the use of CRATs, the IRS issued Revenue Procedure 2016-42 (effective on August 8, 2016) with specific language that allows the CRAT to satisfy the probability of exhaustion test.[16]

CRUT Payouts

The payout rate of a CRUT typically varies from year to year, since it is a percentage of the trust assets as revalued every year.[17] Also, a net-income CRUT payout may vary depending on the income the trust has earned, with the payout being the lesser of the net income earned or a percentage of the trust assets.[18] In the case of a net-income CRUT with a make-up provision, the trustee can pay a percentage of the trust assets as valued for the year, plus any amount of trust income in excess of the percentage to the extent that the trust experienced income deficits in prior years[19]

Income Taxation

A CRT payout is taxed as income according to a four-tier system that accounts for the nature of the income itself:

1. Ordinary income
2. Capital gain income[20]
3. Other income (i.e., tax-exempt interest)
4. Tax-free return of trust principal[21]

Distributions are made according to a "worst in-first out" system for each respective tier. The highest-taxed income in the top tier—ordinary income—is distributed first. If there is both ordinary interest income and qualified dividend income, the ordinary interest income is distributed first. After all ordinary income has been distributed, capital gain is distributed. Within the capital gain tier, net short-term capital gain is distributed before net long-term capital gain.

Ongoing Administration

A CRT has ongoing administrative issues that the trustee must oversee:[22]

- Providing regular investment management of the trust assets
- Filing the trust's tax returns and making an accounting of trust income
- Tracking the make-up amount (in the case of net income make-up unitrusts) when the trust income is less than the payout rate
- Reporting and distributing income—perhaps the most important duty, especially to the beneficiaries

Dormancy and Extinction: The End of the CRT and the Fulfillment of the Charitable Purpose

When a volcanic eruption empties the magma chamber and surface rocks collapse into the empty chamber, the result is a crater—or caldera—where the top of the volcano used to be.[23] When the caldera fills with water, the result is a beautiful lake like Crater Lake in Oregon, which the National Park Service says may be the most pristine lake on Earth.[24] The volcano's explosive power is, in the end, replaced by quiet magnificence.

When the CRT terminates, it must distribute the property remaining in the trust to the charitable remaindermen.[25] At the formation of the trust, the donor can name any number of qualified charities as remaindermen, and may also retain the power to change the charitable remaindermen without compromising the tax-exempt nature of the CRT.

The final distribution from the CRT to the charitable remaindermen marks the end of the charitable remainder trust, and with its extinction, the fulfillment of its ultimate charitable purpose. Powerful and inspiring in its own unique way, a CRT that has finished serving the income needs of the donor can, with its final distribution, provide fertile ground for a charity's important work years into the future.

ENDNOTES

1 "Kilauea," Volcano Hazards Program, United States Geological Survey. https://volcanoes.usgs.gov/volcanoes/kilauea/

2 "Kilauea," Volcano Hazards Program, Geology & History, United States Geological Survey. https://volcanoes.usgs.gov/volcanoes/kilauea/geo_hist_summary.html

3 26 U.S.C. 664(d).

4 26 U.S.C. 2522(c)(2).

5 Treas. Reg. Sec. 1.664-1(a)(2)

6 Treas. Reg. Sec. 1.664-3.

7 26 U.S.C. 664(d).

8 Treas. Reg. Sec. 1.664-2(b).

9 26 U.S.C. 1015 and 26 U.S.C. 664.

10 Treas. Regs. Sec. 1.664-2(a)(1) and Sec. 1.664-3(a)(1).

11 Treas. Reg. Sec. 1.664-2(a)(3)(i).

12 Jessica Ball, "Mount Etna – Italy," Geology.com.

13 26 U.S.C. 664(d).

14 Treas. Reg. Sec. 1.664-2.

15 Treas. Reg. Sec. 1.170A–1(e); Rev. Rul. 77-374, 1977-2 C.B. 329; see also Ltr. Rul. 8152019.

16 Rev. Proc. 2016-42.

17 Treas. Reg. Sec. 1.664-3.

18 26 U.S.C.664(d)(3)(A).

19 26 U.S.C.664(d)(3)(B).

20 The differing treatment of different types of capital gain adds another layer of complexity to the four-tiered tax structure.

21 26 U.S.C. 664(b); Treas. Reg. Sec. 1.664-1(d)(1).

22 The donor names the trustee, which can be the donor, the charitable remainderman, a third party (e.g., attorney, accountant, relative, etc.), or a financial institution with trust powers. The donor may retain the right to change the trustee.

23 "What Is a Caldera?" Geology.com.

24 "Crater Lake: Deep Water in a Sleeping Volcano," National Park Service. https://www.nps.gov/crla/index.htm

25 26 U.S.C. 664(d)(1)(C) and 26 U.S.C. 664(d)(2)(C).

Access more information now!

An electronic copy of our campanion booklet with a detailed discussion of the various types of charitable remainder unitrusts (CRUTs), as well as a case involving a CRUT may be accessed in the Professional Advisor section of our webite at **www.catholicfoundation.com.**

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