THE CATHOLIC FOUNDATION

Shining Light on Charitable Giving: The Right Gift at the Right Time

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Some early civilizations looked on the sun as a deity. In ancient times, the sun also provided a fulcrum for timekeeping and navigation. Popular culture celebrates the sun with music; farmers evaluate how the sun influences economic viability; and scientists study the effect the sun has on the planet. While everyone looks at the same celestial object, individuals interpret what they see from their own unique and very different perspectives—the pious pray, navigators follow, musicians are inspired, scientists learn, and farmers hope for just the right balance of sun and rain.

This is not unlike the way donors view charitable giving—each with a unique purpose and from a distinct perspective. Although anyone can make a gift, every gift is influenced by the donor's specific preferences, goals, and philanthropic vision. A retired donor may give as part of a finely tuned financial and estate plan, looking at the gift as a way to leave a legacy, provide for family members, and reap tax benefits. A younger donor may give as a way to make an impact now on the future of a school, religious organization, or other personally meaningful charity.

Let's look at two important gift strategies that can accomplish specific goals and meet precise planning objectives—charitable gift annuities and charitable lead trusts.

In the Path of Totality: Charitable Gift Annuities Offer Simplicity and Efficiency

A total solar eclipse is an extraordinary event that inspires scientists, laymen, thrill seekers and Sci-Fi fans alike. In 2017, a total solar eclipse occurred on August 21. The "corona" (the crown-like outermost layer of the sun) was visible along a path from Salem, Oregon to Charleston, South Carolina.[1] Within this narrow viewing area, "totality" lasted anywhere from 3½ to 7 minutes.[2] For serious eclipse viewers, this window of time and space was exactly where they wanted to be—free from other distractions and directly in the middle of the process. Indeed, many traveled hundreds of miles to do just that.

In charitable giving, there are some circumstances where it's best to be "in totality" with a simple, straightforward giving tool—one that enables a charitable gift now and a source of income in the future. For donors seeking simplicity without distractions—an easily understandable gift option that doesn't require a difficult process or the involvement of a significant number of other parties—a charitable gift annuity may be the answer.

A charitable gift annuity (CGA) is, of course, part gift and part annuity. It is an agreement between the donor and a qualified charity under which the donor agrees to make an irrevocable gift to the charity, and, in return, the charity agrees to pay a fixed amount periodically to the donor and/or another person designated by the donor (no more than two annuitants are allowed). Typically, the charity will provide a standard CGA contract that offers the donor limited choices depending on the type of CGA and what is permitted under state law. It is important that professional advisors understand state law as it applies to charitable gift annuities.

Funding a Charitable Gift Annuity

Cash is the most straightforward option for funding a charitable gift annuity. It's not only the simplest choice, but it also produces more tax-free income than non-cash gifts. Long-term appreciated stock or mutual funds, however, may provide more of a benefit to the donor. Donating property held for more than one year lets the donor avoid capital gains tax on the gift part of the CGA, and the long-term capital gain realized on the annuity part of the CGA can be evenly spread across each year of the donor's life expectancy.[3]

To take advantage of this method of recognizing long-term capital gain, these requirements must be met:[4]

- The transfer must qualify as a charitable contribution under IRC §170
- The donor must be the only annuitant (or the donor and a designated survivor annuitant)
- The annuity cannot be assignable to anyone but the charity itself

The transfer of the appreciated property is considered a "bargain sale" (a sale for less than the fair market value) and is subject to the IRC bargain sale rules.[5] In addition, the charity itself determines the minimum amount to create a CGA, meaning it may be more accessible for middle income donors than other charitable giving tools.

Annuity Payments and Taxation

The charity sets the payout rates for the charitable gift annuity based on the annuitant's age (generally, the older the annuitant, the higher the payout rate) and whether there are one or two annuitants. However, the CGA must meet the payout rate of 10% of the residuum to charity as required in the IRC.[6] The amount of the annuity payment is set by the CGA contract when created and may not be adjusted.

The donor may choose between immediate or deferred payments. A deferred CGA begins payments at least one year after the date of creation and typically has a higher payout rate. It may also generate a larger charitable income tax deduction for donors who itemize.

The charity observes its own policies and state regulations for the investment and maintenance of the reserve funds where the CGA funds are placed. As required under the agreement, the charity will send the specified payments to the annuitant and will issue a 1099-R form to the annuitants detailing the taxation of the CGA payout (as determined under IRC §72). Initially, the CGA payout can be taxed as income in three ways:

1. **Tax-free return of principal**—Part of the annuity payment is considered a tax-free return of principal until the assumed cost of the annuity (as determined by the IRS tables) has been recovered.
2. **Long-term capital gain**—Part of the annuity payment will be taxed as long-term capital gain if the donor funded the CGA with appreciated property.
3. **Ordinary income**—The remaining amount of the payment is taxed as ordinary income.

Once the annuitant reaches life expectancy, all the amounts attributable to the sale portion will have been recovered and all capital gains on the sale portion will have been recognized, so from that point forward, all income will be taxable as ordinary income.[7]

The Income Tax Charitable Deduction

In the year of the gift, a donor who itemizes receives an income tax charitable deduction for the gift portion of the transfer (i.e., the value of the contributed cash or property less the present value of the annuity payments).

If the donor transfers cash for the annuity, the 50%-of-AGI limitation applies (now 60% for cash, despite the name, due to changes enacted in the Tax Cuts and Jobs Act of 2017). If the donor transfers long-term appreciated property, the percentage limitation is generally 30% of AGI. Any deduction in excess of the applicable percentage limitation may be taken in up to five following tax years.

The donor may make the special election to reduce the amount of the contribution by the appreciation in the property to be eligible for the 50%-of-AGI limitation. The election could make sense if:

- The appreciation element is small, or
- The donor needs a large deduction in the current year.

For the focused donor, the charitable gift annuity might be the right choice. The CGA pairs an easily understandable concept with efficient administration and a good stream of income, in addition to the primary goal of making a significant charitable contribution.

Applying Both the 50% and 30% AGI Limitations in the Same Year

What happens during a tax year when a donor makes both a gift of long-term property subject to the 30%-of-AGI limitation and a gift subject to the 50%-of-AGI limitation? Both AGI limits continue to apply. The overall limit or ceiling remains 50% of AGI—it is not possible to deduct a gift up to 50% (60% for cash), then deduct a separate property gift up to 30%.

Guiding Light: Charitable Lead Trusts Help Reach Multiple Goals

For ancient travelers, the sun was not only a means of navigation, but it was also a primary source of light. A journey began at sunrise and ended when darkness forced voyagers to make camp for the night. Travelers knew better than to waste precious daylight hours, so it was important to take advantage of the opportunity to make progress when light was available.

A similar opportunity exists for individuals who:

- Want to make a significant gift to charity
- Have an asset that produces current but unneeded income
- Wish to maintain the asset for children or grandchildren

In this case, a charitable lead trust (CLT) might be the most useful charitable giving tool.

When a donor places an asset into a charitable lead trust, 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).[8] The annual payment to charity must be either a specified fixed dollar annuity payment (a charitable lead annuity trust or CLAT) or a specified percentage of the annually revalued trust assets (a charitable lead unitrust or CLUT). In either case, the trust is irrevocable, and the donor will have no access to the trust assets until the trust is terminated.

CLT Terminology

Grantor—the individual who creates and funds the trust

Beneficiary—the individual named to receive the property upon trust termination (also known as a remainderman)

Reversion—in a "reversionary" trust, the property reverts back to the grantor at the end of the trust term (as opposed to a "nonreversionary" trust, in which the property is passed to someone other than the grantor upon trust termination)

Lead Interest—the income interest a charity will receive from the CLT

Remainder Interest—the property transferred to the beneficiary at the termination of the CLT

Inter Vivos Trust—a trust created during the grantor's lifetime

Testamentary Trust—a trust created by the grantor's will after death

Qualified—a trust that meets the deductibility requirements of the Internal Revenue Code

CLATs vs CLUTs

The charitable lead trust may be either a charitable lead annuity trust (CLAT) or a charitable lead unitrust (CLUT), depending on the way the charitable income interest is paid:

- In a charitable lead annuity trust, the CLAT pays out a specified, fixed annuity payment—a percentage of the initial value of the trust property as determined at the creation of the trust.[9]
- In a charitable lead unitrust, the CLUT pays out a variable payment—a percentage of the net fair market value of the trust assets as re-valued each year.[10]

In either case, payments must be made at least annually for the length of the trust term, and must be directed to one or more qualified charities as described in IRC §170(c). The trust term can be measured by a specified number of years or by the life or lives of one or more individuals in existence when the trust is created.[11] Generally, the trust may not make any payments other than these income payments to charity until the trust terminates.

Model Trust Language

To assist practitioners and donors, in July 2007 the IRS issued model Charitable Lead Annuity Trust forms (both inter vivos and testamentary) with pre-approved language.[12] Then in July 2008, the IRS issued model Charitable Lead Unitrust forms (both inter vivos and testamentary) with pre-approved language.[13]

Charity

Of course, an important part of setting up a CLT is selecting the charitable beneficiary, which must be an organization described in IRC §170(c). This IRC section, undoubtedly familiar to most, sets out the designation of types of entities that qualify as charitable organizations.

In addition, the grantor may want to identify a secondary charitable beneficiary in case the initial charity subsequently becomes unqualified. Having a secondary charity allows the donor to maintain the continuity of the CLT.

However, the grantor could also reserve the power to change the annuitant in a CLAT. By reserving this power, the grantor would continue to maintain control over the property, and thus would not have made a “complete” gift.[14] As a result, this reservation of power makes the grantor liable for gift tax.

The Four Basic Types of CLTs

Let’s briefly review the four basic types of charitable lead trusts:

1. A **qualified reversionary grantor trust** is an inter vivos trust that pays an income interest to charity for the trust term, after which the remainder interest reverts to the grantor. This is useful for donors who want to make a multi-year pledge to a charity but prefer to take the full charitable deduction in the first year of the trust.
2. A **qualified nonreversionary grantor trust** is a CLT with an intentional defect that results in the grantor being taxed on the trust’s income, thus allowing the trust to qualify for a charitable income tax deduction. A typical defect is if the grantor (or nonadverse party to the grantor) retains the right to reacquire trust property by substituting other property of equivalent value.
3. A **qualified nonreversionary nongrantor trust** is the most common type of CLT. It pays the income to the charity during the trust term and then distributes the remaining trust property to one or more noncharitable beneficiaries other than the grantor. This is a useful planning tool for those who wish to transfer assets to children or grandchildren while making a significant gift.
4. A **nonqualified reversionary nongrantor trust** intentionally violates the requirement that the trust pay a guaranteed annuity or unitrust amount to charity. As a result, the trust does not qualify for an income or estate tax deduction, but will be allowed to claim a gift tax deduction for amounts paid to a charity as these payments occur. What is important to take away is this: although generally no income tax deduction is available (except as just noted), neither is any of the trust’s income taxable to the grantor.[15]

Taxation

While a simple trust must distribute its current income to its beneficiaries, a complex trust does not have such a requirement. A complex trust separates the principal and income of the trust with the income being distributed to the beneficiary.[16] Except as noted above, charitable lead trusts are taxable as complex trusts, for which they can claim a deduction against their taxable income for the amount distributed to charity.[17]

However, the trust must be careful of "unrelated business taxable income" (UBTI). In general, UBTI is the gross income derived by any organization from any unrelated trade or business.[18] For a charity, this would mean any income received by the charitable lead trust that is not related to the exempt purpose of the charity. The IRC states that the deduction for amounts set aside for a charitable purpose under IRC §642(c) will not be allowed for income that is "allocable" to unrelated business income.[19]

At the termination of the CLT, the trust property is distributed to a noncharitable beneficiary. If the ultimate beneficiary of a nonreversionary trust is not the spouse of the grantor, and the transfer was made through an inter vivos CLT, the value of the trust property will be subject to the federal gift tax. However, this amount will be discounted by the net present value of the lead interest paid to the charity (the interest income amount). This noncharitable beneficiary will have a carryover basis in the assets distributed.[20]

Because the value of the income interest going to the charity 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.[21] Except as noted earlier, while the grantor is taxed on the trust income each year (with no corresponding annual charitable deduction), the grantor does receive a charitable deduction in the year of the trust creation. If the trust is created during the grantor's lifetime, the charitable income tax deduction is limited to 30% of AGI because the gift is "for the use of" the charity and not "to" the charity.[22] In addition, if the grantor funds the trust with long-term capital gain property, the 30% limitation also applies if the charity is not a public charity. Any unused deductions due to these limitations may be carried over for the next five succeeding years (or until the unused deduction is used up).[23]

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 heirs without 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 strategy.

Today, using a CLT makes good sense because of the low applicable federal rates (AFRs). The AFR is published by the Treasury department every month to value annuities, life interests or interests for terms of years and remainder or reversionary interests. The AFR is important because a low AFR increases the present value of the charity's income interest. Conversely, this reduces the valuation of trust assets expected to go to non-charitable beneficiaries. So, if the trust corpus appreciates during the trust term, a greater amount of the appreciation escapes transfer taxation when it ultimately passes to family members.

Additional Tax Planning Strategies

If a wealthy donor's goal is to **"zero out" the federal estate tax**, the charitable lead annuity trust (CLAT) is preferable, because an annuity interest can equalize the value of the charitable income interest and the fair market value of the assets transferred to the trust. In order to reach this equilibrium, the trust terms must include a formula based on the number of years for payout as determined by the prevailing AFR at the time of death.

If the donor's plan includes a **transfer of assets to grandchildren** or other descendants that "skip a generation," the grantor must consider the generation skipping transfer (GST) tax.[24] A CLUT's trust terms can include a formula to control the value of the remainder interest so that it equals the decedent's available GST tax exemption at death. A CLAT, however, operates under different rules, allocating the GST tax exemption at the time the trust expires, not at the time it is funded.[25]

An Example

Stephanie owns a strip mall adjacent to a very trendy neighborhood—an income investment she doesn't need now and expects will continue increasing in value. Working with her legal counsel and her favorite charity, Stephanie creates a qualified reversionary grantor charitable lead trust. Essentially, this means that Stephanie (the grantor) creates the trust during life and transfers her commercial property into the trust for the purpose of paying an income interest to the charity for the term of the trust. Once the trust term is complete, her commercial property (the remainder interest in the trust) goes to her children.

Assuming Stephanie is treated as the trust owner for income tax purposes under IRC §671, this arrangement lets her take a charitable income tax deduction in the year she creates the trust, assuming she itemizes. The deduction would be for the net present value of the income interest passing to the charity. However, Stephanie would be responsible for taxes on all income produced by the trust, including income that is distributed to the charity. Stephanie would also be subject to the charitable limitation and reduction rules of IRC §170.

Bring Light to the Shadows

Everyone who watched the 2017 solar eclipse experienced the very rare occurrence of being within the umbra of the moon—the shadow that occurs when the moon moves between the earth and the sun.[26] Unfortunately, when donors plan to incorporate philanthropy into their overall estate and financial plans, they can experience a sort of financial umbra—a shadow that occurs when essential considerations cloud important decisions.

Often, donors are unsure of which assets to donate or how and when to transfer the assets. In addition, they sometimes harbor nagging concerns about the future financial security of their family. All of these misgivings can create shadows that may cloud a donor's ultimate goal. As a professional advisor, you have an opportunity to become a beacon of light, sharing information and experience while assisting donors on a path toward the successful completion of an estate and financial plan that meets all personal and philanthropic goals.

Endnotes

1 "Total Solar Eclipse, August 21, 2017," NASA, 2017. https://eclipse2017.nasa.gov/

2 "How Eclipses Work," NASA, 2017. https://eclipse2017.nasa.gov/how-eclipses-work

3 Reg. Secs. 1.1011-2(a)(4)(ii), 1.1011-2(c), Ex. (8).

4 Id.

5 IRC §1011(b).

6 IRC §514(c)(5).

7 IRC §72.

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

9 Reg. § 1.170A-6(c)

10 Reg. § 1.170A-6(c)(2)(i)(B)

11 Reg. § 1.170A-6(c)(2)(i)(A)

12 Rev. Procs. 2007-45 and 2007-46, released in 2007-29 IRB.

13 Rev. Procs. 2008-45 and 2008-46, released in 2008-30 IRB.

14 IRC §2036(a).

15 Reg. § 25.2511-2

16 IRC §651.

17 IRC §2055(e)(2)(B).

18 IRC §512(a)(1).

19 IRC §681(a).

20 IRC §1015.

21 IRC §2055(e)(2)(B).

22 IRC §170(b)(1)(A), (B); Treas. Reg. §1.170A-8(a) and (b).

23 IRC §§ 170(b)(1)(B), (C)(ii), (D)(ii), 170(d).

24 IRC §2601 et seq.

25 IRC §2642(e).

26 "Eclipses: What Is the Umbra?" https://www.timeanddate.com/eclipse/umbra-shadow.html

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