THE CATHOLIC FOUNDATION

Charitable Trusts: A Return to a Well-Tested Giving Tool

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San Juan Capistrano is a charming town located in Orange County, California, with the Los Rios district and the Mission San Juan Capistrano drawing in tourists who want a look at old California. Some annual visitors have become a tourist attraction all on their own—the swallows of Capistrano. Since the 1930s, the Mission San Juan Capistrano has celebrated the return of the small, orange-tailed Cliff Swallows every March 19, after the birds complete a 6,000-mile trip from Goya, Argentina, back to their nests at the Mission.[1]

While donors and advisors have not strayed quite as far as the swallows, for those who may have explored other giving options in recent years, there are good reasons to return to an old tried-and-true giving tool—the charitable trust. Trusts offer important flexibility and provide a powerful planning option for individuals who want to make a significant charitable gift (average gift size is $550,000), qualify for tax benefits, and also pass assets to heirs.

In this issue, we provide a helpful comparison of charitable remainder trusts and charitable lead trusts for clients who are contemplating making a sizeable donation. There is also a short comparison of charitable trusts with charitable gift annuities.

Charitable Remainder Trusts

A charitable remainder trust (CRT) is an irrevocable trust that provides annual distributions to a named beneficiary (typically the donor or one or more individuals designated by the donor) for a specified period (for life or lives or for a period of years up to 20). At the conclusion of the payout period, the trust's remainder interest is distributed to a qualified charity. With this built-in flexibility, each donor's unique planning needs and preferences 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.[2] 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.[3]

There are two types of charitable remainder trusts:[4]

A charitable remainder annuity trust (CRAT) pays out a set amount every year, determined as a fixed percentage of the initial value of the trust assets. Since the trust is required to make distributions at least annually (including the year in which the trust is created), 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.[5] It is also important to note that additional contributions to the CRAT are not allowed after the initial contribution.[6]

A charitable remainder unitrust (CRUT) pays out a specified percentage of the trust assets as revalued each year,[7] and therefore has much more flexibility than a CRAT. It can accept additional contributions and offers further flexibility through four sub-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

Funding Considerations

Donors often fund a CRT with low-basis, highly appreciated assets (typically stock or real estate). 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.[8]

The donor should not fund the trust with any asset the trustee is obligated to sell, or with tax-exempt securities, S corporation stock, partnership interests, a personal residence, encumbered real estate, or tangible personal property.

Income Beneficiaries

Both the CRAT and the CRUT require that the trust makes distributions to the named income beneficiaries.[9] 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.[10]

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.[11]

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.[12] 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).[13] 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.[14]

CRUT Payouts. The amount of a CRUT payout typically varies from year to year, since it is a percentage of the trust assets as revalued every year.[15] 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.[16] 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.[17]

A NOTE ABOUT THE APPLICABLE FEDERAL RATE

The applicable federal rate (AFR) used in charitable deduction calculations has been historically low in recent years, although it has been rising in 2022. A donor has the choice of using the rate for the month the trust is established or for either of the two months prior. The donor will usually choose the highest rate available to maximize the charitable deduction.

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[18]
3. Other income (i.e., tax-exempt interest)
4. Tax-free return of trust principal[19]

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.

CRUT Varieties

We mentioned earlier that there are four different types of charitable remainder unitrusts—the straight unitrust, which we've been discussing, along with the NICRUT, the NIMCRUT and the flip CRUT. Each has distinct characteristics, but they are tied together through the underlying CRUT concept, wherein an income beneficiary receives income for a specified time and the charity then receives the remainder. Let's briefly review each of the variations.

Net Income CRUT (NICRUT)

Annually, a NICRUT pays out the lesser of:

- a fixed percentage of the trust assets for that year, or
- the net income earned by the trust for the year.[20]

This allows the trustee to make a distribution from the trust, but does not require the trustee to liquidate any of the trust corpus to make the distribution.

Net Income with Make-Up CRUT (NIMCRUT)

A NIMCRUT has a similar income limitation, but it also has a "make-up" provision that allows the trustee to make up any deficiency in the trust distributions in subsequent years.[21] If a trust does not have the income to make a distribution payment as required by the trust agreement, but in a following year the trust has sufficient income and more, the trustee may distribute additional amounts to make up for amounts that should have been distributed in a prior year.

NICRUTs and NIMCRUTs may be useful tools for donors with significant income who hold a valuable, illiquid asset that produces little income. A direct sale of the asset would cause the donor to pay capital gains taxes. However, if the donor contributes the property to a NICRUT or NIMCRUT, the unitrust could sell the property without paying capital gains taxes. The trustee could hold the asset until it could be sold on favorable terms, without worrying about being forced into an ill-timed sale just to pay the fixed-percentage unitrust amount.

"Flip" CRUT

The "flip" CRUT begins as a NICRUT or NIMCRUT, paying out the lesser of the fixed percentage or the income earned by the trust. Typically, the trust will hold an asset that does not produce income, so there is no need for the trust to make any payments. Upon the occurrence of a "triggering event," however, the trust "flips" to a straight, fixed-percentage CRUT for the remainder of its existence.[22]

The change from the NIMCRUT or NICRUT to the fixed-percentage CRUT is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person.[23] This triggering event could be a retirement, marriage, divorce, birth, or death. One exception to the general rule that the triggering event must be outside the control of the donor, trustee, or any other person is the sale of "unmarketable securities" in the trust (such as real estate or restricted stock), which is listed as a permissible triggering event. The trustee then invests the proceeds from the sale into income-producing assets that allow the trust to make the regular annuity payout.

The regulations also require that the flip occurs at the beginning of the taxable year that immediately follows the taxable year during which the triggering event/date occurs.[24] After the flip, any make-up provision may no longer be used.[25]

The NICRUT, NIMCRUT and "flip" CRUT are all good tools to consider if the donor has an asset that is not producing income but will eventually do so. One further consideration: using a CRUT with an income limitation would protect the trust corpus from invasion, which may result in a larger remainder distribution to the charity upon the termination of the trust.

Guiding Clients

A client's objectives and motivations will usually make one form of CRT more appropriate than the others. Consider the following when offering guidance:

CRAT	A donor with an asset that already earns a fixed income (e.g., a corporate or tax-exempt bond or a rental property) or an appreciated asset. An older donor who wants a fixed income.
Straight CRUT	A donor with a long life expectancy (investing the principal for growth, the trust may pay out more income as the trust assets grow or appreciation is realized and paid as income).
Net-Income CRUT	A donor with an asset that is highly appreciated, produces little income, or is difficult to sell, and who has little current need for additional income. (These are often high-earning individuals between 40 and 60.)
NIMCRUT	A donor with no need for additional current income, but who anticipates a need for higher income in the future (perhaps after retirement).
Flip Unitrust	A donor who does not want the trust payout restricted by the net income limitation after the asset is sold or some other triggering event occurs.

Charitable Lead Trusts

A charitable lead trust (CLT) is essentially a mirror image of a charitable remainder trust. It is an irrevocable trust that provides annual distributions to a qualified charity for a specified period of years (not limited to 20 like a CRT) or for the life or lives of designated individuals. At trust termination, the remainder passes to noncharitable beneficiaries (often the donor's children or grandchildren). Because the value of the income interest is tax deductible for federal gift and estate tax purposes, donors often use the CLT to reduce these taxes while ultimately passing ownership to family members or other beneficiaries.

Like a CRT, there are two types of charitable lead trusts. A charitable lead annuity trust (CLAT) provides a fixed-dollar annual payment to charity, so the donor is not allowed to add assets to the trust. A charitable lead unitrust (CLUT) pays out a specified percentage of the value of the trust each year, and because of this revaluation, the donor may add assets to the trust at any point. During the trust term, these charitable distributions are the only income payments allowed. There is not any flexibility to, say, pay out only trust income, or create some other type of payment alternative.

Funding Considerations

The nature of the funding property, the expected income flow, and the desired gift and estate tax deduction will be major considerations in fixing the terms of the trust and the income that is payable to the charitable beneficiary.

Tax law does not impose any direct limitations on the type of property that the donor can transfer to the CLT. However, transferring closely held stock will create serious problems (i.e., private foundation prohibitions) if the value of the charitable interest is more than 60% of the value of the trust.

Transferring appreciated property to the trust does not provide any meaningful advantages or disadvantages. The donor can gain a real advantage, though, by transferring property expected to appreciate substantially in value—any appreciation will not be subject to either federal gift or estate tax when it passes to the remaindermen. Of course, the downside is that the appreciated property will not be eligible for a stepped-up basis, as it would if passed through the estate.

A NOTE ABOUT INTEREST RATES

A donor who creates a CLT is essentially hoping that the trust assets will achieve a higher rate of return than the assigned interest rate (the Section 7520 rate), as this should culminate in a larger tax-advantaged asset transfer to non-charitable beneficiaries. Setting up a CLT during life lets the donor lock in a known interest rate, which is highly beneficial when interest rates are low (as they have been the past few years). As rates continue to increase, the value of the lead annuity will decrease.

Tax Treatment

Unlike a CRT, a CLT is not tax-exempt—the donor will be taxed on all trust income. The specific tax treatment will depend on whether the donor establishes a grantor trust or a non-grantor trust. In exchange, though, a CLT is designed to provide the donor with an immediate income tax deduction. The deduction is limited to 30% of AGI, even for gifts of cash, since the IRS considers this a gift "for the use of" the charity rather than a gift "to" the charity.

CLT Varieties

Besides the choice of a CLAT or a CLUT, the donor must choose whether to establish a:

- **Non-grantor lead trust.** Also known as a family lead trust, this arrangement names one or more individuals other than the donor to receive the remainder. This is not tax-exempt, does not produce an income tax deduction, and may cause gift tax consequences for the noncharitable beneficiaries.
- **Grantor lead trust.** This arrangement reverts back to the donor (or passes to the donor's spouse) after the payments to charity terminate. This produces a current federal income tax deduction for the present value of the income that will be paid to charity in future years.
- **Supergrantor CLT.** This arrangement is a hybrid—a grantor trust for income tax purposes, and a nonreversionary trust for estate and gift tax purposes.

Guiding Clients

As with the CRT, a client's objectives and motivations will usually make one form of CLT more appropriate than the others. Consider the following when offering guidance:

Non-grantor lead trust	A donor who wants to make a gift but ultimately pass assets to family members or others sheltered from federal gift and estate taxes. Most donors prefer this type, especially if they anticipate that the trust income will be less than the charitable payments being made.
Grantor lead trust	A donor who wants to receive a substantial immediate income tax deduction for the present value of the charitable interest (typically to offset particularly high taxable income) by making a "temporary gift" of assets that will eventually revert to the donor (or donor's spouse).
Supergrantor CLT	A donor who is looking for the transfer benefits of a non-grantor trust along with an income tax deduction and preservation of assets.
CLAT vs CLUT	A donor will select one or the other to prioritize the assets going to one beneficiary or the other. A CLAT pays out a specified amount regardless of the performance of the trust assets, which can result in less money going to the donor or to heirs at the end of the trust term. Donors who choose CLATs often make sure a financial professional is in place to monitor and guide investments.

Comparing Charitable Trusts with Charitable Gift Annuities

For donors who are interested in making a life income gift—in other words, those who desire to make an often-sizable donation while securing annual income payments—a charitable trust is not the only way to go. If the selected charitable organization offers charitable gift annuities (CGAs), the donor should consider which option is the best fit. Charitable gift annuities:

- Provide an economical alternative, as they are less expensive to establish and typically require a lower funding amount.
- Are simpler to understand and arrange.
- Offer a charitable income tax deduction (for donors who itemize), a reasonably attractive payout rate, and favorable taxation of annuity payments (no tax on that part of the payout considered a return of principal).
- The option to begin payments immediately or in the future (all other things being equal, a deferred gift annuity will offer a higher payout rate than an immediate annuity).

The fixed annuity amount paid by the charity to the annuitant is based on a payout rate established by the charity. The payout rates, in turn, are based on the age of the annuitant—generally, the older the annuitant, the higher the payout rate. The present value of the annuity must be less than 90% of the value of the property the donor transfers in exchange for the annuity or the transaction will fail to qualify for an income tax charitable deduction. The American Council on Gift Annuities (ACGA) publishes new rates as mortality trends change. New, higher rates took effect July 1, 2022.

CGAs make the most sense for elderly donors—in fact, the older the better, since tax benefits improve as the donor's life expectancy shrinks.

Conclusion

Swallows are the most common migratory bird and, while migrating, instinctively travel in groups for protection.[26] Unlike the swallows, donors may not instinctively know how to protect their own best interests. You can help them properly consider and analyze the entirety of their circumstances and goals. While any type of charitable trust will help a donor fulfill a meaningful philanthropic goal, the choice of trust (or other life income gift) will likely be determined by the donor's other planning goals.

A CRT is often useful for clients who want to:

- Retain an income interest (or give this interest to a spouse or heirs)
- Make tax-efficient use of low-basis, highly appreciated assets
- Reduce estate taxes (typically by using a testamentary CRT)
- Keep ultimate control over the assets

A CLT is better designed for clients who want to:

- Make use of the current income tax deduction while keeping long-term control of the assets (if they are willing to then pay tax on all trust income)
- Take advantage of a low-interest-rate environment (the charitable income interest gets a higher value when the Section 7520 interest rate is low, meaning the charitable deduction is higher)
- Reduce estate and gift taxes
- Make tax-efficient use of assets expected to appreciate significantly

A CGA is a good option for clients who want to:

- Give to an institution that offers charitable gift annuities
- Make a gift and establish a lifetime income in a simpler, more affordable way
- Make use of their advanced age or ability to defer the start of income to secure the best payout rate

Charitable trusts of any type are complex and subject to specific IRS rules. Your knowledge and guidance are necessary to ensure the donor can successfully use the trust to meet specified planning goals.

ENDNOTES

1 journeynorth.org/tm/swallow/OnAMission.html
2 26 U.S.C. 664(d).
3 26 U.S.C. 2522(c)(2).
4 Treas. Reg. Sec. 1.664-1(a)(2).
5 26 U.S.C. 664(d).
6 Treas. Reg. Sec. 1.664-2(b).
7 Treas. Reg. Sec. 1.664-3.
8 26 U.S.C. 1015 and 26 U.S.C. 664.
9 Treas. Regs. Sec. 1.664-2(a)(1) and Sec. 1.664-3(a)(1).
10 Treas. Reg. Sec. 1.664-2(a)(3)(i).
11 26 U.S.C. 664(d).
12 Treas. Reg. Sec. 1.664-2.
13 Treas. Reg. Sec. 1.170A–1(e); Rev. Rul. 77-374, 1977-2 C.B. 329; see also Ltr. Rul. 8152019.
14 Rev. Proc. 2016-42.
15 Treas. Reg. Sec. 1.664-3.
16 26 U.S.C. 664(d)(3)(A).
17 26 U.S.C. 664(d)(3)(B).
18 The differing treatment of different types of capital gain adds another layer of complexity to the four-tiered tax structure.
19 26 U.S.C. 664(b); Treas. Reg. Sec. 1.664-1(d)(1).
20 26 U.S.C. 664(3)(A).
21 26 U.S.C. 664(3)(B).
22 Treas. Reg. §1.664-3(a)(l)(i)(c).
23 *Id.*
24 Treas. Reg. 1.664-3(a)(l)(i)(d).
25 Treas. Reg. 1.664-3(a)(l)(i)(c)(3).
26 https://myanimals.com/animals/wild-animals-animals/birds/the-swallow-the-most-common-migratory-bird/
18 The differing treatment of different types of capital gain adds another layer of complexity to the four-tiered tax structure.
19 26 U.S.C. 664(b); Treas. Reg. Sec. 1.664-1(d)(1).
20 26 U.S.C. 664(3)(A).
21 26 U.S.C. 664(3)(B).
22 Treas. Reg. §1.664-3(a)(l)(i)(c).
23 *Id.*
24 Treas. Reg. 1.664-3(a)(l)(i)(d).
25 Treas. Reg. 1.664-3(a)(l)(i)(c)(3).
26 https://myanimals.com/animals/wild-animals-animals/birds/the-swallow-the-most-common-migratory-bird/

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