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

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 sparrows, 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 wants 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 of ***The Good Advisor***, we provide a helpful comparison of charitable remainder trusts and charitable lead trusts for clients who are contemplating making a sizeable donation.

Charitable Remainder Trusts

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. 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 payout rate of a CRUT 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]

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.

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.

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.

Conclusion

Swallows are the most common migratory bird and, while migrating, instinctively travel in groups for protection.[20] 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 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

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 https://myanimals.com/animals/wild-animals-animals/birds/the-swallow-the-most-common-migratory-bird/

Access more information now!

An electronic copy of our companion booklet with a discussion of the varieties of CRUTs and CLTs, as well as a note on how charitable gift annuities compare to charitable trusts, is available in the *Professional Advisor* section of our website at **www.catholicfoundation.com**.

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