WINTER 2017
VOLUME
XXIX
ISSUE I

THE CATHOLIC FOUNDATION

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?

Professional advisors take this on as part of their mission—to provide clients with careful guidance based on a depth of knowledge, dependable information, and a clear understanding of individual objectives, goals, and hopes for the future. In this issue of ***The Good Advisor*** we take a broad overview of the planning journey, from its basic foundations to a number of attractive charitable giving options—strategies that will help you locate each client's current position and guide them in the direction of long-term goals and objectives.

- **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

A will is usually the foundation of a client's estate plan—a legal document created under state law in which the client defines his or her intentions for the distribution of portions of the estate.

Purpose of a Will: A Roadmap for the Estate

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

- Name an executor (known as a "personal representative" in some states) to handle the administration of the estate.
- Name a guardian for any minor dependents.
- Make decisions that can help minimize taxes and estate administration costs.

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.

5 Ibid.

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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