Nuts and Bolts of Charitable Trusts

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I. Tax Framework for Charitable Giving

a. For the taxpayer to receive a tax benefit, the charitable deduction (combined with other deductions) must be larger than the standard deduction
    i. Standard deduction is now $12,000 for singles and $24,000 for MFJ
    ii. For itemizers, charitable deduction reduces taxable income at highest marginal rate (but it does not offset the 3.8% tax on Net Investment Income)
b. Generally for a gift to be deductible as a charitable contribution it must be:
    i. Voluntary
    ii. made to an eligible charity
    iii. without consideration or benefit to the donor
    (although donor may receive small benefits in return – e.g. sports tickets, dinner, etc.); and
    iv. be a "complete" gift
        1. No strings attached
        2. No ability to revoke
        3. May not be a gift of a partial interest
    v. No deduction for the contribution of services
c. Exceptions:
    i. An undivided portion of a donor's entire interest in the property (e.g. a vertical rather than a horizontal slice)
        1. Cannot gift land, but retain mineral rights. Can give a portion of land and minerals (tenancy in common).
    ii. Remainder interest in a personal residence or farm
    iii. Charitable remainder or lead trusts
    iv. Pooled-income funds
    v. Qualified conservation easements

d. Eligible Charities:
    i. IRS Publication 78 lists eligible charities.
    ii. No income tax deduction for gifts to foreign charities or governmental agencies. However certain US charities are eligible even though some or all of the funds are used in a foreign country.
    iii. Gifts directly to individuals are not deductible

e. Deduction Limitations
    i. Generally gifts are deductible at their fair market value, but there are many exceptions (see attached chart).
    ii. For individual taxpayers, the current year's charitable deductions cannot exceed a certain percentage of adjusted gross income (AGI). The AGI limit is based on the type of property contributed and the type of charity receiving the donation.
    iii. Factors in computing the deduction limitation:
        1. Type of property donated
        2. Type of charity receiving the gift
        3. Fair market value of the gifted property
        4. Donor's basis in the property
    iv. Charitable contributions in excess of the annual AGI limitations may be carried forward 5 years.
    v. It's important to think about these deduction limitation with individuals who routinely give large amounts and/or gifts to private foundation (especially gifts of appreciated property)
    vi. Corporations may make gifts to charities
        1. Limited to 10% of taxable income regardless of the type of property given or whether charity is public or private
        2. Unused deduction can be carried forward 5 years

f. Gifts at death
    i. Generally deductible at fair market value with no limit (this also applies to distributions of trust income to a charity IRC section 642 (c))
        1. However there may be state level restrictions (surviving spouse's right to elect)
    ii. Gift must be made by the decedent to the eligible charity
        1. Cannot be defeated by contingency, event, or person
        2. Deduction is eligible if charity gets the bequest as the result of a qualified disclaimer
    iii. Think about the most efficient assets to leave to charity
        1. Generally, IRAs are the better asset to give to charity at death.
        2. E.g. Donor has 1M IRA and 1M capital asset with basis of 100k. Donor wants charity and his child to receive 1M at his death. If IRA is gifted to child and appreciated asset to the charity, the child will pay income tax on distributions from IRA. If instead, charity receives the IRA, charity is tax exempt and pays no income tax and child receives appreciated asset with stepped up basis.

II. Types of Charitable Planning Tools

a. Direct gifts
b. *Charitable Trusts*
c. Gift annuities
d. Pooled income funds
e. Donor Advised Funds
f. Private Foundations

There are both tax and non-tax reasons for selecting a specific charitable giving vehicle. Selecting the right tool is a matter of looking at the donor's goals, age, risk tolerance, value of gift, and type of asset to be gifted

III. Charitable Trusts

Trust that qualifies for a charitable deduction (income, gift, or estate), but that splits the benefit between a charitable beneficiary and a non-charitable beneficiary.

a. <u>Charitable Remainder Trusts (CRT)</u>
   i. Irrevocable trust in which the donor transfers assets to the trust in exchange for an income interest with the remainder to charity at the end of the trust term.
   ii. Governed by IRC Sec. 664
   iii. Benefits: partial income tax deduction for property transferred, income for life or term of years to grantor or other person, income tax benefits for assets sold inside the trust
   iv. Basic requirements
      1. Trust must pay out at least a 5% annually to the income beneficiary (in some variations the payout can be deferred)
      2. Value of remainder interest must equal at least 10% of the fair market value of the trust at the time the trust is established (for CRTs established prior to July 28, 1997, the threshold was 5%)
      3. Grantor may retain income for life or a term of years (not to exceed 20)
      4. The trust must provide that if the named charitable remainderman is not a qualified charity under the IRC at the time of the distribution, then the distribution must go to an alternate charitable remainderman that is a qualified charity at the time of the distribution and the trust must provide the means by which the alternate charity is selected. The grantor may substitute an alternate charity as the remainderman.
      5. A qualified appraisal is required when the grantor contributes unmarketable assets to the CRT.

v. The governing instrument may permit the trustee of a CRT to make an early distribution of corpus to charity as long as, in the case of distributions in kind, assets distributed have adjusted bases fairly representative of the adjusted bases of all assets available. Further, the governing instrument may provide that the grantor reserves the right to terminate the trust resulting in the acceleration of the distribution to the charity. (See PLR 9138024)

vi. Income tax:

1. Income tax deduction at the time the assets are contributed to the trust
    a. Based on the value of the asset, the term of trust (or income beneficiary's age if lifetime interest), and the 7520 rate. Generally, the higher the payout rate, the lower the deduction.
2. Generally, assets contributed to the trust are removed from the donor's estate for estate tax purposes (see below).
3. No capital gains tax due at the time the asset is sold inside the trust: A CRT is a tax-exempt entity and therefore, upon the sale of an asset, capital or otherwise, the CRT recognizes no gain.
    a. However, donor will pay tax over time as income is distributed out (essentially it is tax deferral rather than elimination)
    b. Appreciated property is best candidate for contribution to CRT.
4. Distributions to the income beneficiary are included in beneficiary's gross income
5. Trustee is fiduciary to both the income and remainder beneficiaries
    a. Generally a prudent investment standard

vii. Charitable Remainder Annuity Trust (CRAT)

1. Pays fixed income (no less than 5% and no more than 50%) to income beneficiaries no less than annually
    a. fixed percent of initial contribution
2. No adjustments to payout based on trust balance
3. No additional contributions permitted (all assets must be transferred simultaneously)
4. Must meet the "5% percent probability test"
    a. There can be no more than a 5% chance that the CRAT will exhaust based on actuarial factors
    b. With a low 7520 rate, very difficult to qualify with a life income term

5. Shifts investment risk to the remainder beneficiary (the charity)

viii. Charitable Remainder Unitrust Trust (CRUT)
    1. Pays fixed percentage of overall trust value paid out no less than annually
    2. Income to beneficiary will vary from year to year based on the value of trust (so it will automatically meet the 5% probability test)
    3. Additional contributions allowed
    4. Distributes risk more evenly between income and remainder beneficiaries
    5. Net Income CRUT (NICRUT)
        a. Pays lesser of payout percentage or distributable net income (DNI)
        b. Look at what is included in DNI in the trust document
            i. May include capital gains realized post funding
    6. Net Income with Makeup CRUT (NIMCRUT)
        a. Allows the trust to build up an account of undistributed payout from previous years
        b. May make up the payout from previous years when income becomes available to pay it
    7. Flip CRUT
        a. NICRUT or NIMCRUT may become CRUT on the occurrence of triggering event
            i. Sale of unmarketable asset
            ii. Certain date
            iii. Birth or death of person
            iv. An event outside the control of the trustee
        b. Useful for gifts of non-income producing assets
            i. Once asset is sold and converted to income producing property can flip to a standard CRUT

ix. Tax consequences of continuing trust income to heirs
    1. Present value of the income to beneficiary is subject to gift tax when funded if irrevocable
    2. Subject to estate tax in donor’s estate if child’s interest can be changed before death
    3. Consider life insurance to replace gift to heirs

x. Assets to avoid contributing to CRT
    1. Debt encumbered property
        a. Bargain sale issues, UBTI issues, can disqualify trust if donor continues to pay the note

2. Assets the donor is already obligated to sell
    a. Will be treated as though the donor had sold it prior to gift with taxable gain to donor
3. S Corp Stock (election revoked)
4. Personal Residence (would be self-dealing to live in residence)
5. UBTI assets
    a. An interest in an active trade or business
    b. Working interest in oil and gas well
    c. Unrelated debt financed income from trading on margin or borrowing
6. Gift Tax implications:
    a. Just the donor as income beneficiary: The donor gets a charitable gift tax deduction for the value of the remainder interest passing to charity (no gift tax implications)
    b. Donor and Spouse as income beneficiaries: The donor has made a gift to his/her spouse of the value of the annuity amount or unitrust amount going to his/her spouse but such gift is covered by the marital deduction (gift tax deduction for remainder to charity)
    c. Someone other than donor and spouse are income beneficiaries: The donor has made a gift to that person in the amount of the present value of the annuity amount or unitrust amount unless the donor retains the right to revoke by will that person's right to the annuity amount or unitrust amount. Such retention of the power to revoke causes the gift to be incomplete and causes the assets subject to the power to revoke to be includable in the donor's estate.
    d. Might consider using insurance for heirs rather than continuing income in CRT to them.
7. Estate tax issues
    a. Generally, When a person transfers property into a trust and retains the right to income from the property or the use of the property, the property must be included in the transferor’s estate (IRC Sec. 2036(a))
    b. Regs. Sec. 20.2036-1 (and amendments thereto) provide detailed guidance on the portion of charitable remainder trusts (CRTs) that must be included in a grantor’s gross estate. (In general, it’s the amount necessary to provide for the decedent’s retained payment without invading the principle.)

c. Donor was sole income beneficiary: The value of the CRT assets is includable in the donor's estate, but such inclusion is covered by the estate tax charitable deduction for the value of the assets passing to charity at the donor's death.
d. Donor and then Spouse as income beneficiaries: The value of the CRT assets is includable in the donor's estate but such inclusion is covered by: 1) the marital deduction for the value of interest going to the spouse; and 2) the charitable deduction for the value of the remainder interest going to charity.
e. Others were designated as income beneficiaries: The value of the CRT assets is not includable in the donor's estate unless the donor retained the testamentary power to revoke such recipient's interests (but subject to gift tax as stated above).
f. Estate tax cannot be paid from a CRT. If such taxes were payable by the CRT, then the CRT would not exclusively operate as a CRT from its inception. The governing instrument must contain provisions for the payment of estate taxes from sources other than the trust itself.
g. May also have a testamentary CRT.

b. <u>Charitable Lead Trusts (CLT)</u>
    i. Irrevocable Trust in which donor transfers assets to the trust; charity receives benefit for a period of time (term of years or life of a person), with remainder going to non-charitable beneficiaries.
        1. Remainder beneficiary may be the grantor (reversionary CLT) or another beneficiary (non-reversionary CLT)
    ii. Used most often for estate tax reduction rather than income tax reduction (may not be cost effective for funding with less than 1M)
    iii. Generally very few and funded with large amounts
    iv. Low 7520 rate is ideal
    v. Can be set up as grantor or non-grantor trust
    CLTs are not tax-exempt entities as are charitable remainder trusts.

    The Tax Reform Act of 1969 mandated that in order for a gift of an income interest to charity to be deductible for income tax purposes, the income earned by the trust would have to be taxable to the grantor. Further, the income paid to charity would have to take the form of a guaranteed annuity or unitrust interest, and be payable at least annually.

1. Non-grantor CLT
    a. Most common format
    b. No charitable income tax deduction (but trust income is excluded from grantor's income)
    c. Estate tax tool – "deferred inheritance"
        i. Qualifies for the gift and estate tax charitable deductions provided the lead interest consists of a guaranteed annuity or unitrust amount
    d. If the non-grantor trust is created during the grantor's life, the grantor receives a gift tax charitable deduction in an amount equal to the net present value of interest payable to charity.
    e. If the trust is created on a testamentary basis, the grantor's estate receives an estate tax charitable deduction, also based on the net present value of the interest.
    f. Depending on the combination of measuring term and income amount payable to charity, it is possible to produce a charitable gift or estate tax deduction that equals the amount transferred thereby creating a gift and estate tax-free transfer.
2. Grantor CLT
    a. Income tax tool – grantor receives income tax deduction in year trust is funded equal to net present value of payments to charity
    b. All income produced by the trust during the trust term, including amounts distributed to charity, is taxable to the grantor.
    c. Useful for donors who desire to make a multi-year charitable pledge and accelerate the charitable deductions
3. Qualified Non-reversionary Grantor CLT
    a. Newer variation that produces both income and gift tax deductions.
    b. Qualifies for a charitable gift tax deduction; however, it contains an intentional drafting defect (*e.g*, a right held by the grantor or nonadverse party to the grantor to reacquire trust property by substituting other property of equivalent value) that causes the grantor to be considered as the owner of the trust's income, which qualifies the transfer for charitable income tax deduction purposes.

c. As long as the grantor retains no estate tax interests or strings, no portion of the trust is includible in the grantor's estate.

4. Nonqualified Non-grantor Reversionary CLT
    a. To qualify for income, gift, and estate tax deductions a CLT must pay a guaranteed annuity or unitrust amount. Nonqualified Non-grantor Reversionary CLTs are intentionally designed to violate this and produce no charitable deductions.
    b. Gift and estate tax deductions are immaterial because the trust will revert to the grantor.
    c. Trust will claim gift tax deductions for income transferred to charity as they occur.
    d. Trust income is not taxable to grantor. It is a complex trust that can claim a deduction against taxable income for amounts distributed to charity

vi. Drafting requirements/guidance

1. The IRS has not published any definitive guidance regarding the mandatory governing provisions required for a CLT to qualify for income, gift, and estate tax deduction purposes. Guidance is found in private rulings.
2. Caution against providing that assets would return to grantor if desired tax benefits are not achieved (instead use a provision that permits trustee to amend the trust for the sole purpose of ensuring that it qualifies for income, gift, and estate tax deduction purposes).
3. Must be either annuity or unitrust amount (like CRTs) paid at least annually
4. Unlike CRTs, no minimum or maximum annuity or unitrust payout rates
5. 5% probability test does not apply
6. Unlike CRTs, no maximum term of years (but must comply with local RAP)
7. Only the donor, spouse, and lineal ancestor or spouse of remainder beneficiary can be used as measuring lives for a CLT.
8. No specific restrictions on additional contributions to CLTs
    a. But any additional contribution to a CLAT will not produce additional tax deductions (because annuity amount must be “determinable with certainty at the time he trust is created” in order to qualify for deduction)

        b. Additional contributions to CLUT will qualify for deduction

    9. Although CLTs are not private foundations, they are subject to many of the same excise tax rules (prohibitions against self-dealing, excess business holdings, etc.)

vii. Generation Skipping Tax Issues

    1. A CLUT which provides for the remainder to pass to a skip person will not pay an additional GST tax if the present value of the remainder interest when the trust is funded is less than or equal to the settlor’s available GST tax exemption amount and sufficient GST tax exemption is timely allocated to the CLUT at inception to fully exempt the remainder.

    2. Special planning consideration regarding CLAT: because annuity amount is fixed, increase in value benefits the remainder beneficiary. As a result the IRS modifies the way the trust inclusion ratio is calculated:
        a. Instead of using FMV of trust assets on date exemption is allocated, the FMV on date immediately after termination is used