Creative Uses of Charitable Trusts

Richard W. Kozlowski, Esq.

Charitable trusts often present over-looked planning opportunities. One such opportunity combines the generation skipping tax exemption with the use of a charitable lead trust. Properly implemented, a gift to a lead trust can benefit both the charity and the grantor's grandchildren without consuming unified credit or paying generation skipping tax.

A second opportunity arises in the case of a closely-held "C" corporation with accumulated ("retained") earnings. A gift of company stock to a charitable remainder trust can effectively make those earnings available to the business owner without the immediate payment of capital gains or income tax.

In order to illustrate these planning opportunities, a primer on charitable trusts is first provided, together with some of the rules governing these types of trusts.

Types of Split Interest Charitable Trusts

Charitable trusts come in many shapes and sizes. Each type of charitable trust has unique characteristics which offer planning opportunities. A brief description of the different types of charitable trusts follows, together with details on the operation of such trusts.

Lead and Remainder Trusts

Split interest charitable trusts (charitable remainder trusts and charitable lead trusts) derive their names from the manner in which benefits flow to charity. When a charitable trust is created, the grantor effectively splits the trust into two pieces: the income stream and the remainder. If the income stream is payable to one or more non-charitable beneficiaries, and a charity (or charities) will receive the remainder, the trust is a "charitable remainder trust." Conversely, if the income stream is payable to the charity, and a non-charitable beneficiary will receive the remainder, the trust is a "charitable lead trust" (sometimes know as a "charitable income trust").

Annuity Trusts and Unitrusts

Charitable lead and charitable remainder trusts each come in two flavors: annuity trusts and unitrusts. Annuity trusts pay a fixed, periodic income to the income recipient (i.e. the charity in a lead trust; the non-charitable beneficiary in a remainder trust). The amount of income is generally a fixed percentage of the value of the assets contributed to the trust (valued on the date of the contribution). Unitrusts also pay periodic income to the income recipient, but the amount of the income is redetermined annually based on a fixed percentage of the fair market value of the trust's assets – which obviously can change from year to year.

There are some wrinkles. For example, a charitable lead annuity trust (a CLAT) can provide for a fixed sum payable for a term or years, switching to a different sum payable for a different term, provided that both sums are fixed upon creation of the trust. No such changes can be made in a

charitable remainder annuity trust (a CRAT). Likewise, a CLAT (as well as a charitable lead unitrust (a CLUT)) can provide that trust income in excess of the annuity amount may be paid to the charitable income beneficiary; no such provision is allowed in a CRAT. Special types of CRUT's allow for the accumulation of income within the trust (see NICRUT's, etc. below).

Grantor and Nongrantor Lead Trusts

Charitable lead trusts are subject to an even further division depending on the income tax consequences desired (discussed below):

A grantor charitable lead trust is designed to give the grantor a charitable income tax deduction for the value of the lead interest gifted to charity. In exchange for this benefit, the grantor is taxed on the income generated by the trust during the term of the lead interest.

A nongrantor charitable lead trust is just the opposite: the grantor receives no income tax deduction for the contribution to the trust, but the tax on trust income is paid by the trust (it is taxed as a complex trust).

More Alphabet Soup: NICRUT's, NIMCRUT's and Flip CRUT's

Some special rules apply to charitable remainder unitrusts (CRUT's) which permit flexibility in the payment of income from the trust to the non-charitable beneficiary.

A CRUT can be drafted to provide that the noncharitable beneficiary will receive the lesser of the trust's annual income or the unitrust percentage. This type of CRUT is known as a "net income charitable remainder unitrust" or NICRUT. For example, if a 6% NICRUT with $100,000 in assets generates $3,000 income for the year, the noncharitable beneficiary would receive $3,000 (the lesser of $3,000 and 6% of $100,000). A further variation on the NICRUT is one which has a "make-up provision;" meaning that if the income in one year falls shorts of the unitrust percentage, it can be made-up in future years where income exceeds the percentage. This type of CRUT is known as a "net income with makeup charitable remainder unitrust" or NIMCRUT.

As if this was not enough, there is a further subvariation of a CRUT known as a Flip CRUT. A Flip CRUT is, in most cases, a NIMCRUT that is funded with property that produces little or no income. When the property is eventually sold, the trust converts from a NIMCRUT to a standard CRUT. This allows larger payments to be made to the noncharitable beneficiary for the remainder of the trust term. Under §664 regulations, three requirements must be met to form a Flip CRUT: (1) The conversion from a NIMCRUT to a standard CRUT must be triggered by a date certain or by an event that is not within the control/discretion of the trustee or other persons (the sale of unmarketable property, marriage, divorce, death, birth are listed as not within such control or discretion); (2) The conversion must occur at the beginning of the taxable year that immediately follows the year in which the triggering event occurs; and (3) Following conversion, the now-standard CRUT must make annual payments to the noncharitable beneficiary using a fixed percentage (no make-up amounts are allowed - all prior make-up amounts are forfeited by the noncharitable beneficiary). See Treas. Reg. §1.664-3(a)(1)(i)(c)(1)-(3).

Other Rules Governing Split Interest Charitable Trusts

Funding

Generally, once a charitable remainder annuity trust is funded, future additions to the trust are prohibited by the Code. The Code does not specifically prohibit future additions to charitable lead annuity trusts, but future additions to these types of trusts make little sense since the payout from the trust cannot be changed and no additional gift tax deduction is allowed for the additions.

Unitrusts, both lead and remainder, are specifically designed to accept future additions. This is because the payout rate is adjusted annually, and is based on the fair market value of the assets in the trust.

Duration

The duration of split interest charitable trusts can vary, but must be fixed by the trust document. They can terminate after the death of an individual, or the joint lives of individuals. They can also terminate after a term of years. In the case of charitable remainder trusts, the longest term of years permitted is twenty (20). The term of CRT's can also be effectively limited by the payout restrictions (see below). Unlike CRT's, charitable lead trusts have no such restrictions on their duration.

Restrictions on Payout

All charitable lead trusts (annuity and unitrust) require an annual (or more frequent) payment to the charitable income beneficiary.

In most cases, charitable remainder trusts also require an annual payment to the non-charitable beneficiary. The exceptions are NICRUT's, NIMCRUT's and Flip CRUT's (discussed above).

For CRAT's, the total annuity amount may not be less than 5% of the initial fair market value of the property placed in trust. For CRUT's, the total fixed percentage payable to the noncharitable beneficiary may not be less than 5% of the fair market value of the trust property (revalued each year). In addition, the fixed percentage for a CRAT cannot be higher than 50%.

Past abuses of these types of CRAT's and CRUT's led to further requirements regarding the payout to the charitable beneficiary. To ensure that the charity receives a portion of the property transferred to the trust, the value of the charitable remainder interest be at least 10% of the value of the property transferred to the trust. Rates set under §7520 rate are used to determine whether this requirement has been met (see Valuation below). A higher payout rate and/or older beneficiary can disqualify a CRT under this requirement. Moreover, if there is more than a 5% probability that the trust will be exhausted before the end of its term, the trust will not qualify as a charitable remainder trust. The 5% rule is generally applied only to annuity trusts, since unitrusts pay only a fixed percentage of the assets on hand, and therefore should never be "exhausted."

Valuation

As discussed above, charitable trusts must have a set duration, either a term of years or measured by the life or lives of the noncharitable beneficiary (ies). The value of the two interests created by the grantor (the income stream and the remainder) will depend in large part on the term of the trust. The longer the term, the greater the value of the income stream and, of course, the lower the value of the remainder.

The value of the split interests also depends, in part, on the prevailing interest rate (known as the "applicable federal rate" or "AFR") and the rate of payout from the trust. A higher AFR equates to a larger remainder; a higher payout rate equates to a smaller remainder. The "applicable AFR" is 120% of the federal midterm rate, rounded to the nearest 0.2%. AFR's are published monthly, but the grantor has the option of using the AFR for the month of the transfer or for any of the two previous months.

Also note that new, proposed regulations would limit the lives that could be used as measuring lives for charitable trusts (see 1.170A-6(e);20.2055-2(e)(3)(iii); 25.2522(c)-3(e)). Under these regulations, only the lives of the donor, the donor's spouse or a lineal ancestor of the remainder (non-charitable) beneficiaries would be valid measuring lives.

In summary, the valuation of remainders and/or income interests is complicated. Luckily, there are a number of commercially available software programs that make this task much easier.

Taxation

Income Tax

During the life of a CRT, income earned by the trust is not subject to income tax. Therefore, if an appreciated asset is transferred to a CRT and then sold, no tax is due on the capital gain generated by the sale. Likewise, interest and dividend income earned by trust investments are also income tax-free. When the annuity or unitrust payment is made to the non-charitable beneficiary, the income is then taxed to the beneficiary.

In contrast, charitable lead trusts can be designed to be either tax exempt or taxable entities. As noted above, a grantor charitable lead trust is designed to give the grantor a charitable deduction for the value of the lead interest gifted to charity, but requires the grantor to pay the tax on trust income during the life of the trust. A nongrantor charitable lead trust provides no income tax deduction to the grantor, but tax on trust income is paid by the trust (it is taxed as a complex trust). These types of trusts are allowed a Section 642(c) deduction for payments to charities. Note that unlike charitable remainder trusts, there is no tier system for the characterization of distributions. Therefore, the trust document should provide its own tier system to ensure the correct ordering of 642 deductions (which may or may not be honored by the IRS – there is little guidance on this issue).

The deductibility of gifts to a charitable trust depend upon the type of charity named as the beneficiary and the type of property contributed to the charitable trust (the following information can also be found at the author's website, www.vermontestateplan.com):

Types of Charitable Organizations

Charitable organizations are divided into two categories which are relevant in determining the limitation on the deduction for a charitable gift. Perhaps the most common are the "50% charities," which include schools, churches, hospitals, and organizations that receive most of their support from the public (such as the Red Cross). The deduction for a gift to a 50% charity is limited to 50% of the donor's "contribution base" (AGI net of any NOL carryback) in the year the gift is made (in other words, you cannot use a charitable gift to write-off more than half of your income in any given year). If this limit is exceeded, the excess deduction can be carried forward for up to five years, subject to the 50% rule in each year.

If a charitable organization is not a 50% charity, it is a 30% charity. This category of charities includes private foundations -- a common beneficiary of CRATS and CRUTS. Deductions for gifts to these charities is limited to 30% of the donor's contribution base in the year the gift is made, and the same five year carry forward rule applies.

Types of Property

Long term Capital Gain Property

Long-term capital gain property is, simply, property which would generate a long-term capital if sold. If long-term capital gain property is donated to a 50% charity, an income tax deduction is allowed for the full fair market value of the gift -- subject to a separate 30% deductibility ceiling. This means that the entire gift is deductible, but that the gift is further limited by the 30% rule.

If long-term capital gain property is donated to a 30% charity, the deduction is (with one major exception) limited to the donor's basis in the donated property. This means that no deduction is allowed for the value attributable to the appreciation of the asset being gifted. This is a key limitation which can make a gift of appreciated property to a CRAT or CRUT undesirable where the ultimate beneficiary is a 30% charity (such as a private foundation). In addition, a separate 20% (contribution base) deductibility ceiling applies for gifts of this type.

The major exception to the above rule is for gifts of publicly traded stock. If you transfer publicly traded stock to a CRAT or CRUT, and the charitable organization named in the trust document is a 30% charity, you are permitted to take a deduction for the full fair market value of the remainder interest. The same 20% contribution base limit and five year carry forward rules apply.

Planning Point #1: Congress continually changes the rules with respect to charitable gifts of appreciated property -- prior to making a gift of appreciated property to a CRAT or CRUT, you should consult a tax advisor regarding the allowable income tax deduction.

Planning Point #2: The donor of a CRAT or CRUT can retain the power to change the charity which will receive the remainder interest (a very attractive feature of charitable trusts). If you

retain this power (which many clients do), and do not limit the permissible donees to 50% charities, the IRS will treat the CRAT or CRUT as having a 30% charity as the beneficiary -- and the more restrictive rules regarding deductions for appreciated property will apply. This is a hidden tax trap: to avoid these limits, your trust document should specifically prohibit you from selecting any organization which is not a 50% charity.

Ordinary Income Property

Ordinary income property is property which would generate ordinary income if sold -- including property which would generate a short-term capital gain. The income tax deduction for a gift of this type of property is always limited to the donor's basis, regardless of the type of charity which will receive the remainder interest.

Gift Tax

As discussed above, gifts to a charitable trust are effectively split into two pieces: the income stream and the remainder, each of which has value. The portion passing to the non-charitable beneficiary (the remainder interest in a lead trust; the income interest in a remainder trust) is subject to gift tax. Since in both cases the gift to the non-charitable beneficiary is a future interest, the annual gift tax exclusion does not apply. Assuming the trust qualifies under the Code as either a lead or annuity trust, a charitable gift tax deduction is allowed for the value of the gift to the charitable beneficiary.

Estate Tax

A major purpose of establishing a charitable trust is often to reduce the grantor's estate taxes. If a charitable remainder trust is established, and the grantor is not the income beneficiary, then the grantor has parted with all of his or her interest in the property, and there are no estate tax implications (other than the add back of any taxable gift in calculating the estate tax). If the grantor is the income beneficiary, then the entire remainder is included in the grantor's estate, but a corresponding charitable deduction is allowed since the remainder passes to charity.

If a charitable lead trust is established, the grantor is usually not named as the remainder beneficiary, and there are no estate tax implications (again, other than the add back of any taxable gift in calculating the estate tax).

The Charitable Lead Trust and the Generation Skipping Tax Exemption

The generation skipping transfer tax (GST) system could be the subject of several pages of discussion without even scratching the surface. However, a detailed knowledge of the GST is not necessary to understand the planning opportunity presented by charitable lead trusts in this area.

Under the GST, every individual has the ability to transfer up to $1 million to a lower generation before the GST is imposed. Much of the planning in this area involves allocation this $1 million exemption to gifts made during life and at death.

A charitable lead trust can be established during the grantor's life, with the grantor's grandchildren named as the beneficiaries. As discussed above, this type of trust results in a gift to the charity for which a charitable gift tax deduction is available, and a gift to the grandchildren.

Prior to 1987, estate planners realized that they could use a charitable lead annuity trust to avoid the GST. Here's how: assume a grantor, aged 60, established a $1 million CLAT with a 25 year term. The AFR is 8%, and the annual payout is $91,877 (a 9.1877% CLAT). Why 91,878? Because this payout reduces the value of the remainder interest to $10, which wipes out any gift tax or GST. If the trust was invested to appreciate at stock market rates (historically around 10%), the corpus of the trust would actually grow to almost $1.8 million in 25 years. This corpus would pass to grandchildren at a zero transfer tax cost (no GST/no gift or estate tax).

Congress found this practice abusive, and changed the rules for CLAT's. Section 2642(e) was enacted to prevent this type of planning. Under this section, the exclusion ratio for a charitable lead annuity trust is no longer calculated when the trust is funded. Rather, the grantor is required to allocate GST exemption at the time the trust is funded. This exemption is then "adjusted" by compounding it annually using the same AFR that was used to calculate the value of lead interest passing to charity. This compounding continues until the lead interest terminates, at which time the assets remaining in the trust are valued. The inclusion ratio is calculated by subtracting from 1 the "applicable fraction," which in this case is the adjusted GST exemption over the value of the remaining trust assets. Therefore, if the adjusted GST exemption is greater than value the remaining assets, the applicable fraction is greater than 1, and the inclusion ratio is zero – no GST is owed on termination of the lead interest. If, however, the if the adjusted GST exemption is less than value the remaining assets, then the inclusion ratio is greater than zero, and some GST will be paid. If the grantor allocates too much exemption, some of it is wasted (see Treas. Reg §26.2642-3(b)); too little, and GST is owed.

Although Section 2642(e) eliminated the ability to make "zero tax" GST gifts to grandchildren, planning opportunities remain. Section 2642(e) governs only generation skipping tax – it is still possible (for charitable lead annuity trusts) to "zero-out" the value of the remainder passing to grandchildren for gift tax purposes. Therefore, a charitable lead trust can be established that has no gift tax implications.

What about GST? If the donor has no other needs for his or her GST exemption, and is charitably inclined, it is possible to use the exemption to effectively shelter the charitable lead trust from GST. Attached to these materials are exhibits which project the activity in a charitable lead trust where the donors have contributed $2 million to the trust, and allocated their combined GST exemptions (also $2 million).

Under prevailing interest rates and (growth) rates of return between 8% and 12%, the charitable lead trust generates a substantial benefit to charity, and a substantial remainder to grandchildren without consuming unified credit (this is a zeroed-out CLAT) and without paying any GST.

Summarized below are the results for a charitable lead annuity trust and charitable lead unitrust at 8%, 10% and 12% rates of return:

Remainder Passing to Grandchildren			
Rate of return	8%	10%	12%
Charitable Lead Annuity Trust	$464,995	$3,868,889	$9,867,098
Charitable Lead Unitrust	$1,278,478	$2,022,622	$3,173,570

These illustrations show that a donor can establish a charitable lead annuity trust for the benefit of charity and grandchildren which has no generation skipping or gift tax implications. In almost every case, the annuity trust is superior to the unitrust.

For several reasons, some caution is warranted. First, the main beneficiary of this type of plan is the charity, not the grandchildren. In all cases, the value of a 25 year lead income interest is much greater that the value of the remainder (which for an annuity trust is zero!). In fact, if the growth rate does not exceed the AFR, the grandchildren will receive nothing (the remainder will be exhausted before the end of the 25 year period). This type of planning is only for donors whose primary objective is a charitable gift. Second, if the growth rate exceeds 12%, the inclusion ratio will not be zero, and GST would be payable at the end of the term. Finally, if the growth rate fall short of estimates, GST exemption will be wasted. Donors should consider other strategies if the GST exemption is needed to shelter other gifts to skip generations.

The Charitable Remainder Trust and Closely-Held Stock

An example best illustrates the use of a charitable remainder trust (CRT) as a planning device for a closely-held business.

The Problem

John Smith, age 65, and his wife Nancy (also 65) are the majority (90%) owners of XYZ, Inc., a company they built from scratch over their lifetimes. The value of XYZ was recently appraised at $4 million, which includes $1.2 million in retained earnings (XYZ is a “C” corporation for income tax purposes). John and Nancy are planning to retire soon, and to transition the business as rapidly as possible to their two children, each of whom own 5% of the stock and are active in the business. They expect to be fully retired in two years, and had planned to use the cash build-up in the company to fuel their retirement.

Most of the couple’s wealth consists of their stock in XYZ ($3.6 million), although they have other, non-income producing assets totaling roughly $1 million (homes, cars, etc.). John and Nancy have consulted with their advisors about the plan to transition the business to their children, their need for retirement income, and their concerns about estate, gift and income taxation. Although they have a basic estate plan which uses their lifetime unified credits to

shelter some assets, their advisors have explained that without further planning, their $4.6 million estate would eventually be subject to taxes of almost $1.8 million. Even if their other assets were sold, and the cash in XYZ was distributed (but subject to income tax), there are insufficient assets to pay the estate tax. Moreover, the couple is worried that XYZ may not produce enough income to fuel their retirement, especially if they begin a program of gifting shares to children as time goes on (John and Nancy need about $70,000 (pre-tax) per year to maintain their lifestyle). They thought about distributing the retained earnings of the company, but realized that the income tax "bite" would leave too little to live on. Advisors have suggested life insurance as a means to replace the wealth consumed by estate taxes, but this does not help with his retirement issues, and actually would create an annual cash drain in order to pay the premiums.

The above-hypothetical is not a rare occurrence. It is estimated that over one in every three family business owners is age sixty or older. During the next fifteen years, with the aging of the baby-boomers, almost 70% of all closely held business will pass to the next generation. Absent an overhaul in the estate tax system, this problem will get worse before it gets better.

The Solution - A Charitable Trust

John and Nancy's advisors have suggested a strategy that appears to solve all of their problems. First, they will create a charitable remainder trust. The trust will pay them an annual income for their lifetimes equal to 8.25% of the value of the property transferred to the trust. At the death of the survivor, the property will pass to a publicly-supported charity of their choice.

Under this plan, John and Nancy will transfer stock representing 30% of the value of XYZ to the trust ($1.2 million worth of stock). The trust will, in turn, sell the stock back to XYZ. XYZ will use the $1.2 million in retained earnings to purchase the stock, and the stock will be retired. The trust will invest the cash proceeds from the sale in order to generate the income needed to make the annuity payments. After the sale, the couple will own about 85% of the company's stock, but its value will have been decreased by the outflow of the $1.2 million in retained earnings.

Why would John and Nancy want to give away $1.2 million? First, they will begin receiving income of $99,000 annually for the remainder of their lives. To help shelter this income, they will be entitled to a charitable income tax deduction of over $191,000, which can offset up to 30% of their adjusted gross income. Their estates will have been reduced by $1.2 million - saving $650,000 in estate taxes. The trust, since it is a CRT, will pay no income/capital gains tax on the sale of the stock back to XYZ. XYZ has rid itself of "trapped" accumulated earnings without the payment of income taxes. Finally, the charity of their choice will receive a substantial benefit, in their name, upon the death of the surviving spouse.

Too good to be true? Maybe. But this is an irrevocable plan - once implemented, it cannot be reversed. In addition, the children are the ultimate beneficiaries of the estate. They will receive $550,000 less under this plan ($1.2 million less $650,000 in estate taxes saved) than they would otherwise. And the couple still faces a substantial estate tax ($1.1 million) on their remaining assets with no cash to pay the tax.

These difficulties can be overcome. John and Nancy need only $70,000 to maintain their lifestyle. Their advisors have suggested that the children purchase life insurance on John and Nancy's joint lives in an amount that will pay the estate taxes due upon their deaths. Since the couple is receiving $99,000 from the CRT, and needs only $70,000 on which to live, they have roughly $29,000 to gift to the children to pay the premiums on the life insurance policy. At their ages (they are in good health), an annual premium of $29,000 will purchase survivorship "whole" life insurance of about $1,100,000 (more if different insurance products are utilized). Since the children own the insurance policy, the policy proceeds pass income and estate tax free to them. These proceeds can be used to pay the estate tax. If the couple begins a systematic gifting program, and they live long enough to reduce their estate while watching their unified credits grow, it is likely that little or no estate tax would be payable on the death of the survivor. The insurance proceeds could then be used to offset the gift to the CRT.