

Charitable Remainder Trusts/Charitable Lead Trusts

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OVERVIEW OF CHARITABLE REMAINDER TRUSTS (“CRTs”) and CHARITABLE LEAD TRUSTS (“CLTs”)

- **CRTs and CLTs are both considered “split-interest trusts”:**
 - Charitable and non-charitable beneficial interests
 - Mix philanthropy with financial needs of settlor and family members
 - Powerful estate and income tax planning tools
 - Section 4947(a)(2) split-interest trust rules apply
- **Keys to CRTs:**
 - Tax exemption provided under Section 664(c) – contributed assets can be sold by CRT on an income tax-free basis
 - Annual upfront payouts to settlor or family members (that carry out income)
 - Remainder interest to charity (deferred gift to charity) – although charitable deductions are available upon funding of CRT
 - Rigid Requirements
- **Keys to CLTs:**
 - Annual payouts to charity (upfront charitable giving) during a “lead term” – reverse of a CRT
 - Transfer of remainder interest to family members with offsetting charitable estate or gift tax deduction
 - Not tax-exempt, but (assuming a non-grantor trust - generally the case) a charitable income tax deduction available to trust under Section 642(c) for payouts to charity
 - Less rigid requirements than CRTs

THE ESTATE TAX PLANNING POWER OF A CLT – AN EXAMPLE

- Individual has very large estate well beyond estate and gift tax lifetime exemption of \$11.4 million.
- Wants to advance philanthropy (through a private foundation) and provide wealth to next generation without estate or gift tax and without using lifetime exemption.
- Transfers \$25 million during lifetime to a CLT in November that pays 6% (\$1,500,000) annually to private foundation for a term of twenty years, remainder to family members.
- The estate/gift tax result:
 - The charitable gift tax deduction is equal to \$25 million, which is the present value of the \$1,500,000 annual payments to the private foundation (based on Section applicable 7520 rate – 1.8% for this example)
 - \$0 Gift - \$25 million gift to CLT is offset entirely by \$25 million charitable gift tax deduction – known as a “zeroed-out CLAT” (can only “zero-out” a CLAT)
 - If the CLT investments grow at a rate of 7% annually, there will be approximately \$30 million left in the CLT upon its termination in 20 years, which passes to next generation estate/gift tax-free.

TWO TYPES of CLTs: CLATs and CLUTs

- Charitable Lead Annuity Trust (“CLAT”) – pays out a fixed annuity
- Charitable Lead Unitrust (“CLUT”) – pays out a unitrust amount, i.e., fixed percentage of fair market value of assets revalued annually
- Effect of Section 7520 Interest Rates:
 - For CLATs, significant effect - the lower the interest rate, the better. (Note: for charitable gifts, can chose Section 7520 rate in month of gift or the two prior months (Sept. – 2.20%; October – 1.80%; November 2.0%)
 - CLUTs have virtually no sensitivity to interest rates
- Generation-Skipping Transfer Tax: GST exemption can be more effectively allocated to a CLUT than a CLAT

CLTs: THE BASICS

- Unlike a CRT, where Section 664 provides a definition of a CRT, there is no separate Internal Revenue Code (“Code”) provision or regulations defining a CLT.
- Instead, certain Sections of the Code provide an income, estate, or gift tax charitable deduction for transfers to a trust that pays a guaranteed annual annuity or unitrust amount to a qualified charity for a period of years. Section 2522(c)(2)(B) (gift tax), Section 2055(e)(2)(B) (estate tax), Section 170(f)(2)(B) (income tax).
 - No minimum or maximum payouts.
 - No minimum or maximum term – can be measured by years or lifetime.
- Unlike a CRT, which is exempt from income tax under Section 664(c), a CLT is not exempt from income tax.
- Income taxation and charitable deduction: Depends Upon Grantor or Non-Grantor Tax Status of CLT
 - Non-Grantor Trust:
 - No income tax deduction is allowed upon creation of the CLT under Section 170(c)(2)(B), but the income of the CLT is not taxed to grantor.
 - CLT is a separate taxpayer –
 - Files Form 1041 (as well as Form 5227)
 - Entitled to an unlimited charitable deduction under Section 642(c) – see outline materials – “Planning for Charitable Contributions by Estates and Trusts” – Section 642(c) controls deduction.
 - No charitable deduction percentage limitation – CLT can be the equivalent of a tax-exempt entity if charitable payouts of CLT equal or exceed gross income.
 - Grantor Trust: Grantor entitled to upfront charitable income tax deduction under Section 170(f)(2)(B) (considered “for the use of” rather than “to” a charity), but grantor subject to tax on CLT income with no further charitable tax deduction.
- Drafting CLTs: see outline materials – “A Guide to the IRS Sample Charitable Lead Trust Forms,” Parts 1 and 2 - cover *inter vivos* grantor and non-grantor CLTs and testamentary CLTs.

CLTs: SELECTED ISSUES TO CONSIDER

- Lifetime CLT – avoid grantor retaining powers causing estate tax inclusion of CLT, including funds distributed to charity - see *Rifkind* and Rev. Rul. 72-552 addressed in outline materials; create special isolated fund within private foundation over which grantor has no say - see outline materials – “A Guide to the IRS Sample Charitable Lead Trust Forms,” Part 2.
- Grantor CLT for individual in high income year – upfront charitable income tax deduction and funds can come back to grantor upon termination of lead term, but grantor is taxed on CLT income.
- Application of Section 4947(a)(2) – trust document must contain certain private foundation language prohibiting certain transactions – prohibitions relating to Sections 4943 (excess business holdings) and 4944 (jeopardy investments) don’t apply if present value of charitable interest does not exceed 60% of amount placed in trust.
- Formula clauses for testamentary CLATs
- “Shark-Fin CLATs” – see outline materials – “Validity of Shark-Fin CLATs Remains in Doubt Despite IRS Guidance”
- GST Exemption: Section 2642(e) – prevents leveraging of the GST exemption through the use of a CLAT
- CLT satisfying annuity or unitrust payments with appreciated securities – taxable gain?

THE INCOME TAX PLANNING POWER OF A CRT – AN EXAMPLE

- Individual, age 65, has substantially appreciated property having a \$26 million fair market value and a \$1 million income tax basis.
- Sale would produce a \$25 million capital gain, subject to immediate capital gain tax and net investment income tax.
- Individual transfers the property to a CRT that pays out 10% of the fair market value of the assets of the CRT (revalued annually) to the individual for his lifetime, remainder to a charity (the present value of remainder interest to charity is \$6,059,040– 23% of value transfer to CRT (minimum required remainder interest must equal 10%))
- CRT subsequently sells the property for \$26 million and invests the funds in a diversified portfolio of assets.
- The income tax result:
 - Because the CRT is exempt from tax under Section 664(c), there is no income tax imposed on the sale by the CRT.
 - Individual would receive an annual payout of 10% of the FMV of CRT assets revalued annually
 - Based on the present value of the charitable remainder interest, there is an available upfront charitable income tax deduction equal to \$6,059,040 (same deduction for gift tax purposes)
 - If CRT was set up to provide for the minimum 10% charitable remainder interest, the annual percentage payout could be increased to 19.203%, producing a charitable income tax deduction of \$2,600,000 (same deduction for gift tax purposes)

TWO TYPES of CRTs: CRUTs and CRATs

- **Charitable Remainder Annuity (“CRAT”)** – pays out a fixed annuity
- **Charitable Remainder Unitrust (“CRUT”)** – pays out a unitrust amount, i.e., fixed percentage of fair market value of assets
- Available for lifetime and testamentary transfers

CRTs: THE BASIC REQUIREMENTS

- **Annual payout to noncharitable beneficiaries:**
 - **Minimum** – 5% (for CRATs, 5% of initial FMV, and for CRUTs, 5% of annual FMV revalued annually)
 - **Maximum** – 50% (for CRATs, 5% of initial FMV, and for CRUTs, 5% of annual FMV revalued annually)
 - Carry out taxable income – worst-in, first-out ordering rule
- **Minimum required value of charitable remainder interest** – 10% (enacted under Taxpayer Relief Act of 1997)
- **Noncharitable beneficiary:** named person or persons – includes an individual, trust, estate, partnership, LLC and a corporation.
- **Term:**
 - For life of named individual noncharitable beneficiaries living at time of creation of CRT, e.g., for life of settlor, followed by spouse, and then children.
 - If for a term of years, no longer than 20 years - Where payments made to a person who is not an individual, payments may only be made for a term of years
- **5% probability of exhaustion test** – applicable to CRATs – see outline materials – “IRS Provides Guidance to Avoid 5% Probability Test for Charitable Remainder Annuity Trusts”
- **Drafting CRTs:** see outline materials – “A Guide to the IRS Sample Charitable Remainder Trust Forms”
- **Governing instrument requirements** – See Reg. Sec. 1.664-1; Section 4947(a)(2)
- **No foot faults allowed** – see *Estate of Atkinson*, 115 TC 26 (2000), aff'd, 309 F3d 1290, 90 AFTR2d 2002-6845 (11th Cir. 2002): see outline materials – “Trustee’s Failure to Administer Charitable Remainder Unitrust in Accordance with Governing Instrument Proves Costly”
- **An alternative** – charitable gift annuity

CRUT VARIATIONS

- **Standard CRUT:** fixed unitrust percentage payout

- **Variations from Standard CRUT:**
 - Net Income CRUT (“NICRUT”): lesser of (i) fixed unitrust percentage payout or (ii) net income

 - Net Income Makeup CRUT (“NIMCRUT”): lesser of (i) fixed unitrust percentage payout or (ii) net income, with limitation in payout in prior years is made up where net income exceed fixed unitrust percentage payout.

 - FLIP CRUT: starts out as NICRUT or NIMCRUT, then “flips” to Standard CRUT upon occurrence of “triggering event”

- **Why do CRUTs have variations but not CRATs?**

- **Why Use a Net Income Limitation? Does it affect charitable income tax deduction?**

- **Why Use a FLIP CRUT?**

- **Definition of Net Income**
 - Prohibition on allocating pre-contribution capital gain to net income

 - Post-contribution capital gain – governed by Reg. Sec. 1.664-3(a)(1)(i)(b)(3) – can be allocated to trust income if permitted by trust instrument and state law

CRTs: SELECTED ISSUES TO CONSIDER

- Settlor should reserve power to substitute charitable remainder beneficiaries
- Unrelated income subject to 100% tax (Section 664(c)(2)); used to disqualify CRT
- **Charitable income tax issues:**
 - Public charity or private foundation as remainder beneficiary – affects AGI limitation and fair market value versus income tax basis deduction
 - Contribution of tangible personal property – deduction deferred until sale and amount of deduction limited to basis because of unrelated use
- **Assignment of income doctrine:** settlor will be taxed if property contributed to CRT is already under legally bound to be sold by settlor
- **Estate and gift tax issues:**
 - Estate and gift tax charitable deduction available for charitable remainder interest.
 - Noncharitable beneficiaries:
 - No gift where settlor is sole noncharitable beneficiary
 - Marital deduction available if spouse is the sole noncharitable beneficiary (other than settlor)
 - Where third parties are noncharitable beneficiaries, gift is made based on calculated value given to third parties (if third parties and spouse are beneficiaries, no marital deduction is allowed)
 - Can prevent a gift to third parties if settlor retains testamentary power to revoke annuity or unitrust payments – gift is then incomplete (may want to do this for non-tax reasons) – causes gross estate tax inclusion
- Possible to avoid Section 4947(a)(2) if no charitable deductions are claimed – see outline materials – “Plan Now to Avoid the Private Foundation Excise Tax Rules”
- **Contribution of Encumbered Property – Caution Required!**
- **Early Termination** - see outline materials – “New Valuation Rules for NICRUT/NIMCRUT Early Termination”