CHAPTER 33

CHARITABLE SPLIT INTEREST TRUSTS

INTRODUCTION

With the exception of pooled income funds and wealth replacement trusts, discussed below, this section deals with charitable split interest trusts that have, as the chapter title implies, split interests, that is, these trusts have both charitable and non-charitable beneficiaries who have vested interests.[[1]](#endnote-1)

A distinction must be made between trusts established *solely* for the benefit of charity (which are deductible without meeting the requirements below), and trusts that have both charitable and non-charitable beneficiaries. Deductions for contributions to this second type of trust are measured by the present value of the ultimate gift to charity.[[2]](#endnote-2) If the charity benefits *before* the non-charitable beneficiary, i.e., it receives annuity or unitrust payments for a specified term and the corpus then goes to the donor’s family or some other non-charitable beneficiary, the trust is referred to as a charitable *lead* trust, where the charity receives the lead interest (discussed in more detail below).

But if non-charitable beneficiaries receive annuity or unitrust payments for a specified period (e.g., for 10 years or for life) and *afterwards* the charity receives the remaining corpus, the trust is called a charitable *remainder* trust. The charity receives what remains after the non-charitable beneficiary's interest ends, i.e. it gets the remainder interest.

Gifts of a remainder interest in trust generally are deductible only if made in one of three ways: (1) a fixed annuity trust; (2) a unitrust; or (3) a pooled income fund.[[3]](#endnote-3)

These three permissible forms of trust are an outgrowth of congressional concern over potential abuses of gifts of a remainder interest in trust to charity. For example, suppose Mr. and Mrs. Wilson are a financially secure, but childless, couple. Mr. Wilson might leave his property to his wife in trust. Mrs. Wilson, according to the terms of the trust, would receive the income for life if she survived her husband. At her death, the principal in the trust would pass to a designated charity. Mr. Wilson would take a current charitable contribution deduction for the present value of the gift that the charity would receive at the death of his wife, the income beneficiary. To counteract inflation and provide for contingencies, a clause might be inserted in the trust agreement authorizing an invasion of principal for Mrs. Wilson’s benefit.

The potential for abuse was that the trustee, by design, would invest the principal in the trust in securities that produced an extremely high income to provide the donor's spouse with as much income as possible, but at the cost (mainly to the charity) of a correspondingly high risk that the principal would be lost or diminished. This situation naturally worked to the detriment of the charitable remainder beneficiary. In addition, the ability of the trustee to make substantial invasions of the principal of the trust further increased the likelihood that little, if any, of the original contribution would be received by the charity. Too often, the result was a significant decrease in the value of the charity’s remainder interest. So the trust, when created, resulted in a deduction that assumed the charity would receive $X when in reality the charity would receive far less – if anything.

For these reasons, a multiplicity of rules were imposed to prevent a taxpayer from receiving a current charitable contribution deduction for a gift to charity of a remainder interest in trust which may be substantially in excess of the amount the charity may ultimately receive (because the assumptions used in calculating the value of the remainder interest had little relation to the actual investment policies of the trust).

Pursuant to these rules, deductions are basically limited to situations where the trust specifies: (a) a *fixed* (read limited) annual *amount* that is to be paid to the non-charitable income beneficiary (i.e., an annuity trust); (b) the amount the income beneficiary will receive in terms of a *fixed percentage* of the value of the trust assets ascertained each year (i.e., a unitrust); or (c) property contributed by a number of donors is commingled with property transferred by other donors, and each beneficiary of an income interest will receive income determined by the rate of return earned by the trust for such year (i.e., a pooled income fund).[[4]](#endnote-4)

A charitable lead annuity trust or unitrust, which is essentially the reverse of the charitable remainder trust, provides that a fixed annual payment, either in the form of an annuity or a unitrust percentage, is made to one or more qualified charities during the term of the trust. At the end of that term, the property is usually transferred either to the donor or members of the donor’s family.[[5]](#endnote-5)

A wealth replacement trust (discussed below) is often used in conjunction with a charitable remainder trust to help replace the loss of value to the family of the donor of the trust assets passing to a charitable remainder trust.

WHEN IS USE OF SUCH A DEVICE INDICATED?

A primary function of a charitable split interest trust is to provide either a present (remainder) or future (lead) economic benefit to the donor or other members of the family, or both, with a present or future transfer to charity which qualifies for income, estate, and gift tax charitable deductions. Refer to the extended discussion of these deductions in Chapter 32.

However, in the case of Charitable Remainder Trusts (CRT), particularly the charitable remainder unitrust, a primary motivation for using the trust is often the transfer of substantially appreciated property by the donor, which will then be sold by the trust. A charitable remainder trust is exempt from federal income tax (unless it has unrelated business taxable income, discussed later) and, therefore, will not be taxed on the gain. The trustee will then reinvest the proceeds from the sale to generate an income yield which will be higher than if taxes had been otherwise paid on the sale. The retained annuity or unitrust interest of the donor (and/or the family of the donor) will be based on the pre-tax value of the property transferred to the trust. In other words, the donor can receive payments on the entire value of the fund, with no reduction for tax on the built-in gain on the transferred assets. As such, it is a very good technique where someone has a highly appreciated asset, and wants to diversify this asset without paying an immediate capital gains tax.

A principal drawback to this concept is the loss of the value of the (after-estate tax) trust assets the donor's family would have received had no charitable gift been made. This leads to the concept of the Wealth Replacement Trust (WRT), generally an irrevocable life insurance trust. The idea is that the additional income the donor receives because of the use of the Charitable Remainder Trust (CRT) can be given by him/her to the WRT and used to pay premiums on insurance on the donor’s life held in the WRT, which ultimately is distributed to the family to replace the wealth (i.e., the value of the assets in the charitable remainder trust that would have passed, had it not gone to charity, to the donor's family). It is important to keep in mind that by deferring the capital gains tax on the sale of the assets, the donor has more money available to be invested and to produce a higher rate of income. In some cases, this higher level of income can cover most of the cost of annual premiums to purchase the life insurance. The age and health of the donor will affect the cost of the insurance and the extent to which this enhanced income stream can cover the cost of the insurance.

WHAT ARE THE REQUIREMENTS?

A Charitable Remainder Annuity Trust (CRAT) is a trust designed to permit payment of a fixed amount annually to a non-charitable beneficiary with the remainder going to charity.[[6]](#endnote-6)

In the basic charitable remainder annuity trust configuration, the donor transfers money or securities to a trust that pays him a fixed dollar amount (a fixed annuity) each year for life. If the actual income generated by the assets of the trust is insufficient to meet the required (promised) annual fixed payment, the shortfall is paid from capital gains or principal. If the annuity trust's actual income is greater than the amount required to be paid out to the non-charitable beneficiary in any given year, the excess income is reinvested in the trust and becomes part of the trust's corpus, eventually going to the charitable remainderman.

The donor's income tax deduction is computed in the year funds are irrevocably placed in trust. It is measured by the present value of the charity’s right to receive the trust assets upon the death of the annuity beneficiary (or at the end of the specified term of years).[[7]](#endnote-7) While the trust is generally irrevocable, the IRS has approved reformations in order to qualify the trust. In addition, the Code does permit certain qualified reformations in order to correct issues with the trust.[[8]](#endnote-8)

The value of the remainder interest is determined by a calculation using actuarial factors based on the beneficiary's age (or the specified term of the trust), the annual amount payable to the beneficiary, and the appropriate monthly IRC Section 7520 rate.[[9]](#endnote-9)

In order to qualify for income (and estate and gift) tax deductions, a charitable remainder annuity trust must meet a number of tests.[[10]](#endnote-10) The primary requirements are these:

1. A fixed amount or fixed percentage of the initial value of the trust must be payable to the non-charitable beneficiary.

2. The annuity percentage must not be less than 5% nor more than 50% of the initial fair market value of all the property transferred in trust.

3. The specified amount must be paid at least annually to the non-charitable beneficiary out of income and/or principal.

4. The trust must be irrevocable and not subject to a power by either the donor, the trustee, or the beneficiary to invade, alter, or amend the trust. However, with certain limitations, while the terms of the trust cannot be changed, the donor can retain the right to change the charitable beneficiary to one or more different qualified charities. In addition, the donor may retain the testamentary right to terminate the non-charitable interest.[[11]](#endnote-11)

5. The trust must be for the benefit of one or more persons (at least one of which is not an organization described in IRC Section 170 (c)) who must be living at the time of the transfer in trust, and their interests must consist of either a life estate or a term of years not exceeding 20 years.

6. The entire remainder must go to charity.

7. The value of the remainder must equal at least 10% of the initial fair market value of all assets transferred to trust. Because the donor must receive at least 5% per year, and at least 10% of the fair market value of the assets must ultimately pass to charity; it is possible that a young donor may not be able to qualify for this type of trust.[[12]](#endnote-12)

If all the necessary tests are met, the donor of a charitable remainder annuity trust will be entitled to an income tax deduction equal to the value of the remainder interest (assuming his contribution base is sufficient to utilize the full amount of the deduction). (See Chapter 32 for discussion of the calculation of income tax deductions for charitable gifts.)

A Charitable Remainder Unitrust (CRUT), like a charitable remainder annuity trust, is basically designed to permit payment of a periodic sum to a non-charitable beneficiary with a remainder to charity.[[13]](#endnote-13) The key distinction is in how the periodic sum is computed.

*Example:* A donor irrevocably transfers money or securities to a trustee. In return, the trustee agrees to pay the donor (or other beneficiary) a unitrust amount from the property for life. The donor also requires that if he predeceases his spouse, she in turn will receive a unitrust amount from the donated property for life. The donor will receive payments based on a fixed percentage of the fair market value of the assets placed in trust. The assets will be revalued each year.

In order to qualify for income, gift, and estate tax deductions, the structure of a charitable remainder unitrust must conform to guidelines set forth in the Internal Revenue Code.[[14]](#endnote-14) These include:

1. A fixed percentage of the net fair market value of the principal, revalued annually, must be payable to the noncharitable beneficiary.

2. The percentage payable to the noncharitable beneficiary must not be less than 5% nor more than 50% of the annual value.

3. The unitrust may provide that the non-charitable beneficiary can receive the *lesser* of: (1) the specified fixed percentage; or (2) the trust income for the year, *plus* any excess trust income to the extent of any deficiency in the prior years (by reason of the distribution being limited to the amount of trust income in such years).

4. The noncharitable income beneficiaries must be living at the time of transfer in trust, and their interests must be for a life estate *or* a term of years not exceeding 20 years.

5. The entire remainder must go to charity.

6. The value of the remainder must equal at least 10% of the net fair market value of the assets transferred to trust. As with the CRAT, a young donor may not be able to qualify in creating a CRUT unless the unitrust amount is payable over a term of years (not to exceed 20) rather than over one or more life expectancies.

An income tax deduction, if allowed at all, is permitted in the year that funds are irrevocably placed in trust. As with the charitable remainder trust, even though the trust is irrevocable, the donor may retain the testamentary right to terminate the *non*-charitable interest.[[15]](#endnote-15)

The deduction is measured by the present value at the date of the gift of the charity’s right to eventually receive the unitrust’s assets, subject to percentage limitations (discussed in Chapter 32). The portion of the deduction disallowed may generally be carried forward for five years (see Chapter 32).

A variation of the CRUT is one in which the payment to the beneficiary is limited to the lower of the set percentage *or* the actual income of the trust. Usually, there is also a provision to “makeup” for any occasion when the income is less than the set percentage. This Net Income with Makeup CRUT (NIMCRUT) has been used a great deal for several years. Such NIMCRUTs have been used as an alternative to qualified pension plans by investing in assets that produced little or no income in the early years (while the donor’s income is high), and then converting to high income investments in years after the donor’s retirement.

A CRUT with a lesser of trust income or the unitrust amount provision may be subject to IRC Section 2702 (see Chapter 26) if: (1) the grantor retains an interest in the CRUT; (2) the CRUT has more than one noncharitable beneficiary; and (3) at least one of the noncharitable beneficiaries is other than the grantor or the grantor’s U.S. citizen spouse. However, Section 2702 would not apply if there are only two consecutive noncharitable beneficiary interests and the grantor holds the second interest. If Section 2702 applies, the gift to the noncharitable beneficiary by the grantor would generally be valued as equal to the value of the property transferred to the trust reduced only by the value of the charity’s remainder interest; interests retained by the grantor would be valued at zero.[[16]](#endnote-16)

A Pooled Income Fund (PIF) is a trust generally created and maintained by a public charity rather than a private donor, which meets the requirements explained below.

The basic requirements are these:

1. The donor must contribute an irrevocable, vested remainder interest to the charitable organization that maintains the fund.

2. The property transferred by each donor must be commingled with the property transferred by other donors.

3. The fund cannot invest in tax-exempt securities.

4. No donor or income beneficiary can be a trustee.

5. The donor must retain for himself (or one or more named income beneficiaries) a life income interest.

6. Each income beneficiary must be entitled to and receive a pro rata share of the income, annually, based upon the rate of return earned by the fund.

If these tests are met, the donor will generally be entitled to an income, gift, or estate tax deduction.[[17]](#endnote-17)

In order to deal with the fact that the assets in a charitable remainder trust will go to charity and not to the family, a “wealth replacement trust” is often used in conjunction with a CRT. A wealth replacement trust is usually an irrevocable life insurance trust that will benefit the remaining family members. Premium payments are usually funded by the income tax savings from the charitable deduction for creating the CRT, and the increase in income from reinvestment of the sales proceeds from the assets that were transferred to the CRT.

As stated above, a Charitable Lead Trust (CLT) is essentially the reverse of a CRT. It is an income tax device that enables a taxpayer to reduce the tax burden of an unusually high income year. If certain requirements are met, the taxpayer will be allowed a current income tax deduction for the value of the annuity or unitrust interest (the present value of the stream of dollars) given to a charity. Anything remaining after the trust's obligation to pay the charity's annuity ends passes to the specified non-charitable beneficiaries.

The trade-off for the large up-front current deduction is that the donor will be taxed on the income the trust earns each year (under the grantor trust provisions (see Chapter 19)). This means that the grantor *must* be treated as the owner of such interest under IRC Section 671 in order to obtain a current income tax deduction. Also, the charity must receive either a guaranteed annuity or a fixed percentage of the annual net fair market value of the trust assets.[[18]](#endnote-18)

If for some reason the taxpayer is no longer taxed on the annual income of the trust, there will be a partial recapture of the previously allowed deduction, which must be reported by the taxpayer as income in that year. For example, if the individual contributes the income for five years but dies within three years of this contribution, recapture would be triggered. His income for the year of his death would have to include a recaptured portion of the excess deduction that he took at the time the trust was established.[[19]](#endnote-19)

An alternative income tax plan is one in which the CLT is not a grantor trust and there is no deduction at the time of transfer to the CLT. This plan is often used where the goal is to avoid percentage limitations on gifts to charities, and to avoid the amount going to charity from the CLT each year being treated as income to the donor.

Alternatively, the transfer can be made at death, in which case there is no income tax deduction, but there is a step-up in income tax basis of the assets going into the trust.

Another use of the CLT is to permit the transfer of assets to the next generation at a very low transfer tax value (a portion of such value having been given to charity). This situation typically arises where the assets within the CLT are expected to increase in value at a rate higher than the Section 7520 rate.

The CLT works like this: The donor transfers income-producing property to a trust. The trust in turn will provide the charity with a guaranteed annuity (i.e., a charitable lead annuity trust), *or* annual payments equal to a fixed percentage of the fair market value of the trust property as annually recomputed (i.e., a charitable lead unitrust). At the end of the specified period, the property would be returned to the donor, or go to a noncharitable beneficiary of the donor’s choice. Since the noncharitable beneficiary is receiving the money in the future, the value of this future gift is reduced to an amount equal to the present value of that future gift. In some cases, the duration of the charitable interest can reduce the amount of this future gift to zero.

As long as the donor has a reversionary interest in the income or the principal of the trust that is greater than 5%, or is otherwise considered the owner of the income or principal under the grantor trust rules (see Chapter 19), he can take an immediate deduction at the inception of the trust. The deduction is based on the present value of the charity’s future rights to annuity or unitrust payments and is subject to the percentage limitations described in Chapter 32.

A lead trust structured in such a way ensures that the income from the property held in trust, while payable to the charity, is includable in the donor’s income. The donor does not receive an income tax charitable contribution deduction each year of the trust for the income payable to the charity, but does receive a charitable contributions deduction in the year the trust is funded for the present value of the payments the charity is to receive over the ensuing years. The donor would not receive this deduction unless he was considered the owner of the annuity or unitrust amount (as described in IRC Section 170(f)(2)(B)).

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

As explained previously in the chapter, split-interest trusts are essentially trusts with both charitable and non-charitable beneficiaries that have both (1) assets for which a charitable deduction was allowed for income, estate, or gift tax purposes and (2) unexpired noncharitable interests. There are two kinds of split-interest trusts: charitable remainder trusts (the most common) and charitable lead trusts.[[20]](#endnote-20)

As discussed in Chapter 32 (Charitable Contributions), since community property is owned equally by the spouses, a contribution of community property to a split interest trust that benefits only one of the spouses may be treated as a gift, and may be taxable if it does not qualify under both the federal and any state marital deduction rules.

In most states, however, a gift of community property into a charitable remainder trust does qualify for the marital deduction as long as the grantor and spouse are the only non-charitable beneficiaries.

A gift into a charitable lead trust is attributable, one-half, to each of the spouses. Therefore, each spouse would be considered a “grantor” as to the half contributed by him or her.

A gift of community property can only be validly made with the consent of both spouses.

FREQUENTLY ASKED QUESTIONS

**Question** – What factors should be examined in deciding between an annuity trust and a unitrust?

*Answer* – The choice between an annuity trust and a unitrust involves a number of considerations. An annuity trust is indicated where simplicity in administration is desired since there is no need for an annual revaluation. (At least 5% of the initial fair market value of the trust property must be distributed in the case of an annuity trust, whereas if a unitrust is used, there must be a distribution of at least 5% of the trust’s fair market value as re-determined *each year*.) Furthermore, depending on payout rate, and age of the annuitant, the annuity trust may yield a larger charitable contribution deduction. Generally, if the payout is greater than the current valuation table interest rate, the unitrust will produce a larger value for the remainder interest than would the annuity trust.

There are, however, a number of disadvantages of an annuity trust when compared with a unitrust. First, inflation may cause a fixed annuity to lose some of its value. Of course, the unitrust may, under adverse circumstances, also fail the income beneficiary. If investment results are poor, the life income beneficiary may experience an absolute loss of income. This will result in both an inflation loss and a diminution of the dollar amount of his annual payment. On the other hand, if the trustee of the unitrust is skillful, he may be able to enhance the value of the principal fund and, consequently, the dollar amount of the annual payment.

A second disadvantage of the annuity trust is caused by regulations providing that the governing instrument in the case of an annuity trust must prohibit any additional contributions from being made.[[21]](#endnote-21) This is probably done to confine the trust to a single valuation date. It therefore becomes impossible to pour over future testamentary bequests into the trust or to have other grantors make inter vivos additions to the already created trust, rather than having to set up new trusts for the same purpose. Conversely, regulations specifically permit additional contributions to unitrusts if the governing instruments contain provisions regarding the effect of such an addition upon valuation and the unitrust amount payable.[[22]](#endnote-22) If trust income is less than the required percentage payment in a unitrust, the liquidity problem could be avoided if the noncharitable beneficiary is willing to forgive all or a part of any particular year’s payment, an act tantamount to a contribution to the trust.

A third disadvantage of an annuity trust is that the specified annuity must be paid each year regardless of whether there is sufficient trust income. If the corpus of the trust were real property, such as an apartment house, and if rents were to fall below the specified annuity plus expenses, the trustee would have to borrow against the property or sell it to make the required payments. However, if the trust instrument so provides, a unitrust can limit its payout to the income beneficiary to the actual trust income. In later years, if trust income exceeds the percentage regularly distributable, the deficiency could be made up by excess distributions. This is referred to as a Net Income with Makeup Unitrust (NIMCRUT).

**Question** – A client is considering transferring $100,000 to a trust that will pay him $5,200 a year for life, with a remainder to charity. How will his charitable contribution be determined?

*Answer* – The client’s deduction would depend on his age at his nearest birthday. As Figure 33.1 illustrates (arbitrarily assuming a 5.0% Section 7520 rate), a 55-year-old donor would receive a $30,354 deduction. A 65-year-old would receive a $43,879 deduction for the same contribution.[[23]](#endnote-23)

**Figure 33.1**

|  |  |  |  |
| --- | --- | --- | --- |
| **CHARITABLE REMAINDER ANNUITY TRUST**  **(One Life - Table 2000CM)** | | | |
|  |  |  |  |
| Transfer to Trust: | $100,000 | Annuity Payment: | $5,200 |
| Age: | 55 | Frequency of Payments: | Annual |
| Payments: | End of Period | Section 7520 Interest Rate: | 5.0% |
|  |  |  |  |
| Valuation |  |  |  |
| Ann. Factor (Age 55, 5.0%): | 13.3935 | Adj. Factor (Annual, 5.0%): | 1.0000 |
| Annuity Value: | $69,646 | Charitable Contribution: | $30,354 |

**Question** – Assuming the same facts, how would the result be different if the client were to transfer $100,000 to a charitable remainder unitrust, retaining an annual payment equal to 5% of the value of the trust each year?

*Answer* – The donor would receive $5,000 the first year. If the value of the trust had increased to $120,000 a year later, the donor would receive 5%, $6,000, and so on each year. If the income of the unitrust were insufficient in a given year to pay the stated percentage, capital gains or principal could be used (but need not be, if the trust so provides) to make up the deficit.

**Question** – A 67 year old donor places $250,000 in a charitable remainder unitrust, retaining a payment equal to 9% of the annual value of the trust, payments to be made quarterly at the end of each period. What is the total income tax deduction available to the donor?

*Answer* – Assuming the use of a 5.0% Section 7520 rate, the donor’s deduction would be $74,280. The computation is illustrated in Figure 33.2.

**Figure 33.2**

|  |  |  |  |
| --- | --- | --- | --- |
| **CHARITABLE REMAINDER UNITRUST**  **(One Life - Table 2000CM)** | | | |
|  |  |  |  |
| Transfer to Trust: | $250,000 | Unitrust Payout Rate: | 9.0% |
| Age: | 67 | Frequency of Payments: | Quarterly |
| Months Until First Payment: | 3 | Section 7520 Interest Rate: | 5.0% |
|  | | | |
| Adjusted Payout Rate Factor (Quarterly, 3 months, 5.0%): | | | .970057 |
| Adjusted Payout Rate [9.0% x .970057]: | | | 8.731% |
|  | | | |
| One Life Unitrust Remainder Factor (Age 67, 8.6%): | | | .30161 |
| One Life Unitrust Remainder Factor (Age 67, 8.8%): | | | .29476 |
| Difference [.30161 - .29476]: | | | .00685 |
| Interpolation Adjustment (8.731%): | | | .00449 |
| Unitrust Remainder Factor [.30161 - .00449]: | | | .29712 |
|  | | | |
| Charitable Contribution [$250,000 x .29712]: | | | $74,280 |
|  | | | |
| Unitrust Interest [$250,000 - $74,280]: | | | $175,720 |

**Question** – How can a charitable remainder trust be used to generate estate tax savings?

*Answer* – The estate tax deduction created by the use of a qualified charitable remainder trust is measured by the value of the remainder interest that will pass to charity, using the same tables applied in connection with trusts created during life.

Figure 33.3 shows the federal estate tax savings possible for a 67 year old woman, through an inter vivos charitable remainder trust. The “without charitable trust” column shows the results for a widow who makes no provisions for a charitable remainder trust (or outright donation). In this situation her taxable estate is $8,000,000. If the same individual created a charitable remainder trust, which is funded in January 2013, with $2,000,000 and provides for a 9% payout. This Charitable Remainder Unitrust (CRUT) will generate a deduction of $580,680; her taxable estate would be reduced considerably. In addition, a current income tax deduction would have been obtained for the value of the remainder interest of the property donated.

**Figure 33.3**

|  |  |  |
| --- | --- | --- |
| **ESTATE TAX SAVINGS USING**  **A CHARITABLE REMAINDER TRUST**  **(assume death occurs in 2013)** | | |
|  |  |  |
|  | *Without Charitable*  *Trust* | *With Charitable*  *Trust* |
|  |  |  |
| Adjusted Gross Estate | $8,000,000 | $8,000,000 |
| Charitable Contribution | \_ | 580,680 |
| Taxable Estate (Tentative Tax Base) | $8,000,000 | $7,429,320 |
| Estate Tax Before Unified Credit | $3,145,800 | $ 2,917,528 |
| Unified Credit | $2,045,800 | 2,045,800 |
| Estate Tax after Unified Credit | $ 1,100,000 | $ 871,728 |
| Net Estate Cost of $2,000,000  Charitable Contribution  Is $1,771,728 ($2,000,000 - $228,272)  In addition, there is the income tax benefit of the $580,680 income tax deduction | $228,272 Estate Tax Savings | |

**Question** – A client, who is 68 years of age, has been approached by her alma mater with a request that she make a sizeable contribution. She would like to transfer $100,000 to the university, but believes she will need the income generated by that amount to live on the rest of her life. The university maintains a pooled income fund that is producing an annual return of 6%. What would be her total charitable deduction?

*Answer* – As illustrated in Figure 33.4, the client would be able to deduct $44,887.

**Figure 33.4**

|  |  |
| --- | --- |
| **POOLED INCOME FUND**  **(One Life - Table 200CM)** | |
| Transfer to Trust: | $100,000 |
| Rate of Return: | 6.0% |
| Age: | 68 |
|  |  |
| One Life Remainder Factor (Age 68, 6.0%): | .44887 |
|  |  |
| Charitable Contribution ($100,000 x .44887): | $44,887 |

**Question** – A client is a physician with a large annual income from her practice. She has reached the maximum limits on her qualified retirement plan, and is seeking a method to invest in such a way that she can accumulate funds tax-free for her retirement. Could a charitable remainder trust be of any use to her?

*Answer* – The client may want to consider what is sometimes called the net income charitable remainder unitrust. As noted in the text, this is a trust in which the annual payment is the lesser of the fixed unitrust percentage or the actual income generated by the trust.

An optional provision in such a trust is called the makeup provision. Under that provision, if the actual unitrust payment in any year based on the income is less than the unitrust percentage, the net difference is carried over to later years, so that in any subsequent year in which the net income exceeds the unitrust percentage, the amount carried over can be paid (so long as the total does not exceed the actual income).

Assume the physician in this example contributes $20,000 per year to such a trust, and the trustee invests in maximum growth, minimum income investments. Assume the unitrust percentage is 6%, and the actual income is in the range of 2 to 3%. The trustee would distribute only the actual income for the next several years, during which the donor will build up a substantial carryover credit. When the physician is ready to retire, the trustee changes the investments to maximum growth, and is now able to pay the entire amount of income to the donor because of the makeup provision. This plan functions much the same as a deferred annuity. In some cases, it may be helpful to have the trust purchase an annuity so that the distributions from the annuity contact will be treated as income to the trust. The IRS has approved the purchase of an annuity within a charitable remainder annuity trust.[[24]](#endnote-24)

Again, life insurance may be a key element in such a plan. It can function as a wealth replacement vehicle in the manner just described. It can also be used as a hedge against the premature death of the client. In other words, since the purpose of this technique is to provide for retirement, there will be a substantial economic loss if the client dies before retirement, or early into retirement.

**Question** – If an appreciated asset is transferred to a charitable remainder trust, does the donor, the annuity or unitrust beneficiary, or the charity pay an income tax or capital gains tax if that asset is sold by the trust and the proceeds are reinvested?

*Answer* – None of the parties to a charitable remainder trust would have any immediate income tax liability on the sale because charitable remainder trusts are exempt from income tax (except in years when they have unrelated business income). Therefore, a charitable remainder trust can accumulate, free of income or capital gains tax, any income in excess of that needed to satisfy its annuity or unitrust obligations to the non-charitable beneficiaries.

This fact would also allow the donor to receive a greater income than he otherwise would be able to, since if he sold the asset without transferring it to the trust, he would have to pay income or capital gains taxes.

However, as distributions are received from the trust by the noncharitable annuity or unitrust beneficiary, part of each distribution may be taxed to that beneficiary as ordinary income or capital gain from sale of the asset by the trust. The method by which this is calculated is called the tier system.

**Question** – How can a charitable lead trust be used for estate tax savings?

*Answer* – A charitable lead trust can be used for purposes of estate tax savings. As explained above, property is placed in the trust. A fixed amount of the income the property produces is paid annually to a charity for a specified period of time (this is the front-end or lead period). At the end of that period, full ownership of the property and the income it produces passes to non-charitable beneficiaries, such as the children or grandchildren of the trust’s grantor.

When property is placed in the trust by bequest, an estate tax deduction is allowed for the actuarial value of the front-end annuity interest. As illustrated in Figure 33.5, a $747,732 estate tax deduction would be allowed (arbitrarily assuming a 5.0% Section 7520 rate) if a client left a $1,000,000 bequest in trust to pay $60,000 a year to The American College for 20 years. Stated another way, the deduction could remove about 75% of the trust property from the taxable estate. Furthermore, the property would go intact to the donor’s family after 20 years. And, by properly combining the annuity payout level and the duration of the annuity period, it might be possible to eliminate an even greater amount of estate tax. For example, an annuity payout of $80,000 for 20 years would result in a deduction of $996,976 (arbitrarily assuming a 5.0% Section 7520 rate). Furthermore, those same remainder beneficiaries could be named as trustees and, therefore, control the property they someday will own. If the trust property earned a return greater than the 5.0% Section 7520 rate which is assumed, the actual amount of funds within the trust (which will pass to the heirs) will increase.

**Figure 33.5**

|  |  |  |  |
| --- | --- | --- | --- |
| **CHARITABLE LEAD ANNUITY TRUST**  **(Term Certain)** | | | |
|  |  |  |  |
| Transfer to Trust: | $1,000,000 | Annuity Payment: | $60,000 |
| Age: | 20 | Frequency of Payments: | Annual |
| Payments: | End of Period | Section 7520 Interest Rate: | 5.0% |
|  |  |  |  |
| Check Exhaustion of Trust Fund |  |  |  |
| Ann. Factor (20 years, 5.0%): | 12.4622 | Adj. Factor (Annual, 5.0%): | 1.0000 |
| Annuity Test Value: | $747,732 | Special Factors | Not Required |
|  |  |  |  |
| Valuation |  |  |  |
| Ann. Factor (20 years, 5.0%): | 12.4622 | Adj. Factor (Annual, 5.0%): | 1.0000 |
| Charitable Contribution: | $747,732 | Remainder Value: | $252,268 |

**Question** – What is a wealth replacement trust?

*Answer* – A wealth replacement trust (sometimes called an asset replacement trust) is an irrevocable life insurance trust, which is used in conjunction with a charitable remainder trust, to replace the assets the heirs of the donor of a charitable remainder trust would be losing, because the assets would be passing to the charity after the non-charitable income beneficiaries’ death.

*Example:* Assume a client, who is in a combined 48% federal and state estate tax bracket transfers $1,000,000 worth of appreciated stock to a charitable remainder annuity trust, retaining a 6% annuity interest for himself. After his death, the assets pass to a charity of his choice. Had he not created the trust, his heirs would have inherited $520,000 ($480,000 would have been the total federal and state estate tax). Therefore, to replace the amount his heirs would have been disinherited by, he created an irrevocable life insurance trust, which can purchase insurance on his life.

Because the client receives immediate tax benefits upon establishing a charitable remainder trust (through an income tax deduction), and because the client would have an increased cash flow with the trust (since the trust paid no income tax on the sale of the assets, which could be reinvested at a potentially higher yield), the funding for the premium on the life insurance policy held in irrevocable life insurance trust can, in many cases, be achieved between the tax savings and the increased cash flow without any additional outlays by the client.

**Question** – A client has a sizeable block of stock in a company that he started and has since taken public. He is now able to sell that stock. However, the stock has an income tax basis of $100,000 and a current market value of $1,100,000. How might he use the wealth replacement trust concept? Assume a 10% investment return.

*Answer* **–** Depending upon the taxpayer’s taxable income,under current capital gain rates for assets held for more than 12 months, the client would pay federal income tax of $150,000 ($1,100,000 - $100,000 basis = $1,000,000; $1,000,000 x 15%), and would be left with $950,000 ($1,100,000 - $150,000). Note, under the American Taxpayer Relief Act of 2012, the 15% capital gains rate is increased to 20% for married taxpayers whose taxable income exceeds $450,000 and $400,000 for single taxpayers. If the amount of that capital gains tax were reinvested at 10%, he would have an annual yield of $95,000. Assume, instead, that the client transfers the stock to a charitable remainder annuity trust, in which he retains a 10% annual annuity. The trustee sells the stock, pays no income tax, and pays the client an annual annuity of $110,000 per year for life, which is $15,000 per year more than if the client had simply sold the stock and reinvested the proceeds.

However, the client’s family will lose a potential inheritance of $1,100,000, *plus* the future growth in that investment (but *minus* the federal and state death taxes that would have to be paid on that amount). Assuming the investment would double in value by the time the client dies (based on the client’s life expectancy and an anticipated growth rate of the property), his net loss of wealth would be $1,900,000 (2 x $950,000) *minus* federal and state estate tax of $912,000 (assume a combined death tax of 48% x $1,900,000), or $988,000.

If the client is insurable, the client could replace this lost wealth by purchasing approximately $988,000 in life insurance, which would be owned either directly by his potential heirs or by an irrevocable trust for their benefit. If the annual premiums for such insurance were less than $15,000, the transaction would produce a net economic savings to the client.

CHAPTER ENDNOTES

1. . For more detail on these trusts, see *The Tools & Techniques of Charitable Planning*. (National Underwriter Co.). [↑](#endnote-ref-1)
2. . IRC Sec. 170(f)(3) which generally provides that no deduction will be allowed for the contribution of a partial interest in property unless the contribution if of a: (i) remainder interest in a personal residence or farm, (ii) an undivided portion of the taxpayer’s entire interest in property, and (iii) a qualified conservation contribution. In *Upen G. Patel, et ux. v. Commissioner*, 138 T.C. No. 23, (June 2012) the court denied a charitable deduction to the taxpayer for permitting a local fire company to destroy the house as part of a training exercise. The court reasoned that this was not the contribution of an undivided property interest, but was more like the grant of a license. [↑](#endnote-ref-2)
3. . IRC Secs. 170(f)(2)(A), 664(d). But see the discussion of gifts of a partial interest in Chapter 32 for an exception. [↑](#endnote-ref-3)
4. . IRC Sec. 170(f)(2)(A). [↑](#endnote-ref-4)
5. . IRC Sec. 170(f)(2)(B). [↑](#endnote-ref-5)
6. . IRC Secs. 664(d)(1), 2055(e)(3); Treas. Reg. §20.2055-2(a). [↑](#endnote-ref-6)
7. . Charitable trust calculations can be performed on NumberCruncher Software. [↑](#endnote-ref-7)
8. . PLR 201125007. See also IRC Sec. 2055(e)(2) relating to qualified reformation of trusts. [↑](#endnote-ref-8)
9. . A complete history of Section 7520 rates can be found at http://www.leimberg.com under Free Resources. [↑](#endnote-ref-9)
10. . IRC Secs. 170(f)(2)(A), 664(d)(1). [↑](#endnote-ref-10)
11. . Treas. Reg. 1.664-2(a)(4). [↑](#endnote-ref-11)
12. . Rev. Rul. 79-368,1979-2 CB 109. [↑](#endnote-ref-12)
13. . IRC Sec. 664(d)(2). [↑](#endnote-ref-13)
14. . IRC Sec. 664(d)(2). [↑](#endnote-ref-14)
15. . Treas. Reg. 1.664-3(a)(4). [↑](#endnote-ref-15)
16. . Treas.Reg. §25.2702-1(c)(3). [↑](#endnote-ref-16)
17. . IRC Sec. 642(c)(5). To calculate the deduction for a contribution to a pooled income fund: (1) take the highest rate of return for the previous three years, (2) look to Valuation Table S in Appendix B for that rate, (3) find the proper age of the donor, (4) proceed to column 4 to find the appropriate remainder factor, and (5) multiply the factor by the amount contributed to obtain the deduction. [↑](#endnote-ref-17)
18. . Treas. Reg. §1.170A-6(c). [↑](#endnote-ref-18)
19. . Treas. Reg. §1.170A-6(c)(4). [↑](#endnote-ref-19)
20. . Adapted from "Trusts: Common Law and IRC 501(c)(3) and 4974" by Ward L. Thomas and Leonard J. Henzke, Jr., IRS Exempt Organizations -Technical Instructions Program for Fiscal Year 2003. [↑](#endnote-ref-20)
21. . Treas. Reg. §1.664-2(b). [↑](#endnote-ref-21)
22. . Treas. Reg. §1.664-3(b). [↑](#endnote-ref-22)
23. . The computation of these amounts and all like amounts referred to involve the following steps (and of course charitable split interest trust calculations can be performed on NumberCruncher Software at http://www.leimberg.com ):

    For both annuity trust and unitrust computations, age is determined as of the individual’s nearest birthday. Treas. Regs. §§20.2031-7A(d)(1)(ii), 1.664-4(e)(5).

    In the case of an annuity trust, go to Valuation Table S (reproduced in Appendix B) to determine the value of an annuity at the given age. Arbitrarily assuming a Section 7520 rate of 5.0%, in the case of a person age 55 this is 13.3935. Also, the principal sum is $100,000 and the annual annuity payout is $5,200. The value of the annuity equals $69,646 ($5,200 x 13.3935). The value of the remainder is $30,354 ($100,000 - $69,646).

    In the case of the unitrust, go to IRS Publication 1458, Table U(1). The value of a remainder interest after a 5% unitrust payout at age 55 is .32836. This factor applied to the principal sum of $100,000 is $32,836, the deduction allowed. (The actual payout rate may require adjustment under Table F, also found in Publication 1458, to reflect the number of months by which the valuation date precedes the first payment.)

    It is interesting to note that the value of a charitable remainder interest of a residence in the hands of a noncharitable tenant may be greater for gift tax than for income tax purposes because no deduction for depreciation is required for gift tax purposes. Rev. Rul. 76-473, 1976-2 CB 306. For relevant decisions regarding the federal estate tax deduction for charitable remainders, see Rev. Rul. 76-543, 1976-2 CB 287, as amplified by Rev. Rul. 77-169, 1977-1 CB 286, and distinguished by Rev. Rul. 83-158, 1983-2 CB 159; Rev. Rul. 76-545, 1976-2 CB 289, as clarified by Rev. Rul. 82-97, 1982-1 CB 194; Rev. Rul. 76-546, 1976-2 CB 290; Rev. Rul. 77-385, 1977-2 CB 331; Rev. Rul. 87-37, 1987-1 CB 295. [↑](#endnote-ref-23)
24. . PLR 201126007. [↑](#endnote-ref-24)