Charitable Trusts

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Gifts to charitable trusts can be during lifetime or at the time of death. Charitable trusts provide an income interest to a person, persons, or charities for a period measured by the person's life or a term of years. The remainder interest after the death of the person receiving the income or after the term of years, may pass to a charity or to the trust creator's heirs.

Charitable Remainder Trusts

Lifetime charitable remainder trusts usually provide for an income interest for the creator of the trust or the creator and his or her spouse. These trusts can provide an additional source of retirement income, allow disposal of appreciated property without capital gain, provide an income tax deduction on contribution, and remove the contributed property from the donor's estate. CRTs can convert low income property into higher income property and provide additional retirement income for you and your spouse.

When a charitable remainder trust is created, a donor transfers cash or property to an irrevocable trust but retains for himself (or himself and other non-charitable beneficiaries) an annual income payment from the trust. At the end of a specified term for the income payment, or upon the death of all the non-charitable income beneficiaries, the then remaining trust property is distributed to the charity or charities the donor has specified in the trust.

Types of Charitable Remainder Trusts

There are two types of Charitable Remainder Trusts (CRTs). They are the Charitable Remainder Annuity Trust (CRAT) and the Charitable Remainder Unitrust (CRUT).

The difference between the two types of charitable remainder trusts is in the type of income payment reserved. In an annuity trust, the income payment reserved is based on a fixed percentage of the trust assets valued at the time the assets were contributed to the trust. An unitrust is designed so that the trust assets are valued each year and the income payment is a fixed percentage of the changing value of the trust as it grows (or decreases) from year to year. In other words, the annuity trust is a fixed annuity and the unitrust is a variable annuity. The fixed percentage for an annuity or unitrust cannot be less than 5% nor more than 50% of the initial net fair market value of the trust property. The income payment from both types of CRTs may continue for the lives of the designated income beneficiaries or the payment may be for the lesser of 20 years or the income beneficiaries' lives.

The main advantage of an annuity trust is that the annuity payment is fixed regardless of the investment performance of the trust. However, inflation may erode the value of a fixed annuity payment over time. Managing an annuity trust is also simpler than an unitrust because there is no requirement to do an annual valuation of the trust assets. The only required valuation is upon the initial contribution of assets to the trust. The primary disadvantages of an annuity trust are that the person creating the trust can only make an initial contribution when the trust is created and the income payment cannot be adjusted to conform with the income needs of the income recipient.

Unitrust charitable remainder trusts provide an inflation hedge because the amount paid to the income beneficiaries fluctuates with changes in the fair market value of the trust assets. As the value of the trust assets increases, so does the amount of the unitrust payment. Also, persons creating an unitrust may make additional contributions at any time. The main disadvantage of an unitrust is the requirement for an annual valuation of trust assets. However, this annual valuation requirement is not onerous if the assets of the trust are publicly held securities with values listed on a stock exchange.

Unitrust Income Payments

There are three types of income payments permitted with unitrusts.

a. An unitrust may provide an income payment that is a fixed percentage of the annually redetermined value of the trust assets. Such an income payment will fluctuate annually with changes in the value of the trust assets, but the percentage paid of the annual value will always be the same. Such unitrusts are called fixed or normal CRUTs.

b. An unitrust may also provide for an income payment which is the lesser of a fixed percentage of the annual value of trust assets or the actual income earned by the trust assets. Such trusts are called net-income-with-makeup CRUTs or NIMCRUTs. With a NIMCRUT, taxable income distributions to the income beneficiaries may be controlled by changes in investment strategy. Investing in high growth, low income assets will reduce income payments to the income beneficiaries and increase the trust remainder for ultimate distribution to the charity beneficiary. NIMCRUTs may contain make-up provisions for years when income paid to the income beneficiaries is less than the fixed percentage. The make-up provisions allow payments of the deficiencies in prior payments as soon as the trust has income in excess of the fixed percentage.

c. Unitrusts may also provide for an automatic change from an income payment which is the lesser of a fixed percentage or actual income (NIMCRUT) to an annual payment of only the fixed percentage (normal CRUT). That change from a NIMCRUT to the normal CRUT may be based on the occurrence of a specific event such as the sale of specific trust assets, a marriage, the death of a specific person, or the trust creator or another individual reaching a specific age. Trusts that change from a NIMCRUT to a normal CRUT on the occurrence of a specific event are called flip CRUTs. Flip CRUTs can be used to supplement other sources of retirement income by timing the flip with the age the trust creator wishes additional retirement income. Prior to the flip the trustee can invest in growth assets that produce little income. After the flip, the trustee can change the investment strategy to produce more income to satisfy the fixed percentage payment without reducing the principal that will pass to the charitable remainder beneficiary.

Property contributed to a lifetime CRT is removed from your estate for estate tax purposes as long as the income interests retained are limited to the person making the contribution and his or her spouse. This result occurs because the person making the contribution only retains an income interest for life and when he or she dies the remainder interest goes to a charity entitled to the estate tax charitable deduction. If the person making the contribution also reserves an income interest for his or her spouse, the interest reserved for the spouse will qualify for the estate tax marital deduction if the person creating the trust dies before the spouse. If an income interest is reserved for anyone other than a spouse, the reserved income interest will be subject to estate tax based on its present value on the death of the person creating the trust. When a CRT is created at the death of a person, it is called a testamentary charitable remainder trust. Testamentary charitable remainder trusts provide an estate tax charitable deduction for the value of the remainder interest. If the spouse is the income recipient, his or her income interest is entitled to the estate tax marital deduction. When someone other than the surviving spouse is provided the income interest, the actuarial value of the income interest is subject to estate tax.

Income Tax Treatment of CRTs

Charitable remainder trusts do not pay any income tax and they will shelter from capital gains tax any proceeds received on the sale of appreciated property owned by the trust and any dividends or interest income received. This tax-exempt status allows the assets in the trust to grow faster than if the sales proceeds, dividends, and interest were taxable. It also allows a person creating a charitable remainder trust to diversify investments and retain income from such diversification without having a taxable gain. Highly appreciated assets can be contributed to a charitable remainder trust and the trustee can sell the assets and reinvest the proceeds without a taxable capital gain. The income from the newly diversified portfolio can then be paid to the person who created the trust. Income beneficiaries of charitable remainder trusts are only taxed on the income payments they receive.

The income tax deduction for a contribution to a charitable remainder trust is treated as an itemized deduction on the schedule A to your form 1040 return. The amount of that deduction is the present value of the remainder interest that will pass to the specified charities at the end of the trust term. This amount depends upon the income beneficiaries' ages, the annuity or unitrust percentage to be paid from the trust, the frequency of annuity or unitrust payments, the time between the valuation of the trust assets and the first income payment, the type of property contributed to the trust, and the type of charities chosen as remainder beneficiaries.

The younger you are when you create a charitable remainder trust the lower your income tax deduction for property contributions to the trust. If you provide for two or more income beneficiaries, the income tax deduction depends upon the combined life expectancies of all the income beneficiaries. The higher annuity or unitrust percentage you choose for payments from the trust, the lower your income tax deduction. This result occurs because a higher income payout reduces the expected remainder that will pass to charity.

The more frequent income payments and the less time between the initial valuation and the first payment both will reduce the amount of your income tax deduction. Increased frequency of payments and less time until the first payment both serve to reduce the build up of the trust principal that will ultimately pass to the charities who receive the trust remainder.

Charitable Lead Trusts

The reverse of a charitable remainder trust is a charitable lead trust. Charitable lead trusts provide an income interest to charities for a term of years and the remainder interest passes to the trust creator's heirs after the term is up. Charitable lead trust are not exempt from income tax, but they do provide significant income tax, gift tax, and estate tax deductions.

Charitable lead trusts are irrevocable trusts created during life or at death which provide an income interest to a charity or charities for a term of years or for the life of a named person or persons. After the term of years or the death of the named person or persons, the remaining trust property may be distributed or continued in trust for the trust creator's descendants. The estate tax value of the remainder left to the heirs can be very low if the income percentage paid to the charity is high or the income term is long.

Types of Charitable Lead Trusts

Charitable lead trust income payments to charity must be in the form of either an annuity or a unitrust payment made at least annually. Charitable lead trusts providing an annuity payment to charities are called Charitable Lead Annuity Trusts (CLATs). As with a charitable remainder annuity trust, the annuity payment is a fixed sum usually expressed as a percentage of the initial value of the assets contributed to the trust. This fixed annuity payment must be made each year until the charitable term ends regardless of whether the trust assets increase or decrease in value. Charitable lead trusts providing unitrust payments to charities are called Charitable Lead Unitrusts (CLUTs). A charitable lead unitrust payment is made in the same manner as a charitable remainder trust unitrust payment. The charity is paid an annual payment equal to a specified percentage of the value of the trust assets redetermined each year. If the trust assets increase in value, a unitrust payment will increase; and, if the trust assets decrease in value, a unitrust payment will decrease.

Estate and Gift Tax Treatment of Charitable Lead Trusts

When a lifetime charitable lead trust is created, the trust creator makes a split gift with part of the gift being made to the charity and part to the remainder beneficiaries of the trust. The actuarial value of the charitable income interest qualifies for the gift tax charitable deduction. The value of the remainder interest will be subject to gift tax or will use the donor's lifetime gift tax applicable exclusion amount, currently $5,490,000. Since the gift of both interests was made during life, it is likely that none of the value of the charitable lead trust will be subject to estate tax when the donor dies. The only instance in which this would not be true is if the gift tax applicable exclusion amount were to be decreased to an amount below the value of the remainder interest transferred to the trust. If this were the case, the difference between the applicable exclusion amount in effect at the date of the donor’s death and the remainder interest gift to the trust would be taxable to the donor’s estate.

If a testamentary charitable lead trust is created at death, the donor's estate will receive an estate tax charitable deduction for the actuarial value of the charitable income interest. The donor's taxable estate will include the value of the remainder interest.

Charitable lead trusts can be a very effective estate planning tools for those cases where the parents and their children are well off and need no additional income. The transfer of the parent's property to the grandchildren can be deferred for a period of 20 to 30 years and a charity can benefit during the interim. The estate tax value of the remainder left to the heirs will be very low if the income percentage paid to the charity is high or the income term for the charity is long. Further, if the trust is structured properly, the value of the trust property will grow during the charity's term and all the growth will also escape estate taxation.

Income Tax Treatment of Charitable Lead Trusts

Depending on the trust terms, charitable lead trusts may be treated in two different ways for income tax purposes. If a lifetime charitable lead trust is created with the donor retaining certain powers, it will be classified as a grantor or acceleration trust. Acceleration trusts provide the donor an income tax deduction for the present value of the charity's income interest when the trust is created. However, the annual income of the trust is still treated as the donor's income for income tax purposes. Acceleration trusts work best for donors who are experiencing a year or two of unusually high income and are in need of an up front income tax deduction.

The second type of lifetime charitable lead trust is called a non-grantor or exclusion trust. The creator of an exclusion trust does not retain any powers that would make the trust a grantor trust. For an exclusion trust, the donor does not receive an up front income tax deduction, but is permitted to exclude from his or her taxable income any income generated by the property contributed to the trust.

Any income tax deduction for a contribution to a charitable lead trust is treated as an itemized deduction on the schedule A to your form 1040 return. The amount of the deduction is the present value of the income interest to be paid to the specified charities during the income term.

Value of Estate Tax or Income Tax Deduction

The actuarial value of a charitable lead trust income interest depends upon the income percentage paid to charity, the term of the charitable lead, the frequency and timing of charitable payments, and an assumed interest rate referred to as the Internal Revenue Code §7520 rate.

The estate tax or income tax charitable deduction will be larger and value of the taxable remainder left to descendants will be smaller if:

a. A higher percentage is paid to charity.

b. The charitable lead term is longer.

c. Charitable payments are made more frequently during the year or are made at the beginning of the year.

d. The §7520 rate is lower when the trust is created.

The value of the taxable remainder left to descendants may be reduced to zero, if the charitable lead term is long or the percentage payment to charity is high. For example, a $10,000,000 charitable lead annuity trust with a 15 year term and an income payment of 9% annually at the beginning of each year would have a zero value remainder interest with a §7520 rate of 4.6%. Despite the assumption of a zero remainder value for estate or gift tax purposes, the trust assets would have an actual value of approximately $5,330,000 at the end of the charitable lead, if trust investments yielded an 8% annual growth.