

## A Primer on Charitable Trusts (CRTs, PIFs, CLTs)

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One of the more popular ways of making a partial interest gift to charity is through use of a Charitable Remainder Trust. Charitable Remainder Trusts (CRTs) allow the donor to retain an income stream on property transferred to the trust. When the trust terminates, amounts remaining in the trust are transferred to a charitable organization.

There are two types of CRTs: Charitable Remainder Annuity Trusts (CRATs) and Charitable Remainder Unitrusts (CRUTs). CRATs pay a fixed percentage of the initial contribution to the income beneficiary each year. Since the payout is conditioned on a fixed percentage of the initial contribution to the trust, it does not change from year to year – it is a fixed annuity interest. A CRUT pays a fixed percentage of the annual value of the trust to the income beneficiary each year. A CRUT, therefore, will have a variable income stream. As the value of the trust increases, the value of the income distribution will increase. As the value of the trust decreases, the value of the income distribution will decrease. Only CRTs that are structured as CRATs or CRUTs will qualify for the charitable income tax deduction.

**EXAMPLE:** Ryan created a trust that pays him an income stream equal to 7% of his initial \$1 million contribution to the trust (\$70,000 per year), and the remainder interest in the trust, upon termination, will be paid to a charitable organization. Ryan has created a CRAT and the value of the remainder interest that is transferred to charity will qualify for an income tax charitable deduction.

**EXAMPLE:** Wally created a trust that pays him all of the trust income each year, and the remainder interest in the trust, upon termination, will be paid to a charitable organization. Even though Wally has given a remainder interest in the trust to charity, Wally will not be entitled to a charitable income tax deduction. Wally's trust distributes all trust income to him each year, not a fixed percentage of either the initial contribution (a CRAT) or the annual value of the trust assets (a CRUT), so it does not receive the tax benefits associated with CRTs.

In addition to structuring the trust as a CRAT or CRUT, there are three requirements that must be met in order to qualify the trust for a charitable income tax deduction. The three requirements are: (1) the income payout requirement; (2) the term requirement; and (3) the remainder value requirement.

A CRT must have a payout rate of not less than 5%, nor more than 50%, of the initial contribution to the trust (in the case of a CRAT) or the annual value of the trust (in the case of a CRUT). Failure to have a payout rate within this range will disqualify the trust for the income tax charitable deduction.

The term requirement limits the term of a CRT to either (1) the life of a specified individual, such as the income beneficiary; or (2) a term of years that does not exceed twenty. A CRT must be created either for the life of the beneficiary or a term of years, but may not be created in a manner that uses both a life contingency and a term of years (for example, it would be impermissible to create a trust for the longer of Twenty years or the life of the income beneficiary).

Finally, the remainder value requirement states that the remainder value of the CRT must be worth at least 10% of the initial contribution at the time of creation, and each time additional contributions are made to the trust (contributions after creation are only permissible if the trust is a CRUT; CRATs do not permit additional contributions after creation of the trust). If a CRT is created for a term that references the life expectancy of some individual, actuarial considerations are taken into account in determining the value of the remainder interest. This implies that if a very young person is named as the measuring life for determining the term of the income interest for the CRT, the value of the remainder interest may be small, and may not meet the 10% minimum value requirement. Usually, the 10% minimum value requirement will not be violated with a term trust, unless the payout rate on the CRT is high. Failure to meet the 10% minimum remainder interest value will disqualify the trust for the income tax charitable deduction.

CRTs offer several benefits to the taxpayer. First, the taxpayer may deduct the present value of the remainder interest that is reserved for charity as an income tax charitable deduction. Generally, charitable deductions are only permitted when a donor gives his or her entire interest in cash or property to a charity. When a CRT is formed, the charity does not get anything – it only benefits once the trust terminates. If the trust has been exhausted before the trust term expires, the charity will receive nothing. Nevertheless, a charitable deduction is permitted upon creation of the trust equal to the present value of the remainder interest that will (eventually) go to charity. Since the remainder interest requirement sets the minimum value of the remainder interest at 10% of the contribution to the trust, the charitable deduction that the taxpayer receives upon creation of the trust will be at least 10% of the contribution to the trust.

Second, if appreciated property is donated to a CRT, the donor will not be required to recognize the gain on the asset at the time of transfer. Usually, transfer of an asset in return for something else causes a realization event to occur for income tax purposes, which generally requires recognition of the gain and the payment of tax. Transfer of an asset to a CRT, however, will not trigger a realization event for income tax purposes. Since a CRT is not a tax-paying entity, subsequent sale of the asset by the CRT will not require the immediate payment of an income tax (although, when the income beneficiary receives distributions from the trust, he or she will be treated as receiving a distribution of taxable income on which income taxes must be paid). Since the contribution of the asset to the CRT or the subsequent sale of the asset by the CRT will not cause a taxable event, it is possible for the taxpayer to diversify a concentrated position without having any leakage in the portfolio caused by taxes.

**EXAMPLE:** Kasey worked for Emerald Isle, Inc. for 30 years. Over his career, Kasey participated in the employee stock purchase plan offered by the company, which allowed employees to purchase corporate stock at a 15% discount from fair market value. Over his career, Kasey purchased \$80,000 worth of stock, which now has a fair market value of \$500,000 and represents a substantial portion of his non-qualified portfolio. Kasey retired last month, and would like to supplement his retirement income. If he sells his stock, he will have to pay ordinary income tax on the discount portion of his purchases, and capital gains tax on the remaining portion of the gain. Instead, Kasey contributes the stock to a CRT that will pay him an income stream for the rest of his life, with the remainder interest payable to a charity he will designate in the future. Kasey will be entitled to take a charitable deduction for the value of the remainder interest that is reserved for charity (a minimum of \$50,000 in this example), he will not have to pay any taxes on the gain attached to the stock he transferred to the trust, and the trustee of the CRT can sell the stock, and invest the proceeds in a diversified portfolio of investments that will generate income to meet the income payouts.

The third benefit of a CRT is evident from the structure of the trust – either the grantor or the grantor’s designee retains an income interest in the trust for the specified trust term. If the income stream is payable to the grantor or the grantor’s spouse, there will be no gift or estate tax consequences. When the grantor gives the income stream to someone other than his or her spouse, a gift of the present value of the income interest results, and may require the payment of gift tax.

While the CRT itself is not subject to tax, the income beneficiary is subject to income tax on the distributions received from the trust to the extent that those distributions are considered distributions of income. The Code imposes an ordering rule for income distributions that requires the highest taxed forms of income to be distributed to the income beneficiary before lower taxed or non-taxable distributions are made. The general ordering rule requires all ordinary income of the trust to be distributed to the beneficiary first. Once the accumulated ordinary income of the trust has been distributed to the beneficiary, the beneficiary will be deemed to receive the capital gains generated by the trust. When all of the accumulated capital gains have been distributed, tax exempt income will be distributed to the beneficiary. If the Trust has distributed all of its tax-exempt income, subsequent distributions to the beneficiary will be treated as a non-taxable return of capital.

When designing a CRT it is important to take into consideration the grantor’s purpose in setting the trust up. Often, CRTs are used to supplement income, and the grantor may wish to receive an income stream that increases over time to keep up with inflation. When increasing income streams are desired, a CRUT (Charitable Remainder Unitrust) would be the best form of CRT, since the income distribution will be a fixed percentage of the annual value of the trust. As long as the value of the assets inside the trust continue to increase, the income stream will also continue to increase. When a client creates a CRUT, it is usually better to pick a lower payout rate, for two reasons.

First, the charitable deduction will be higher (all else equal) for a trust with a lower payout rate when compared to a trust with a higher payout rate; and (2) the lower payout rate will permit the assets inside the trust to grow over time, thereby increasing the income payout.

**EXAMPLE:** Liam creates a CRUT with highly appreciated stock, and retains the income stream to supplement his retirement income. The payout rate for the CRUT is 10%, implying that Liam is entitled to receive 10% of the value of the trust each year. If the assets of the trust are growing at a 10% rate, Liam will be withdrawing all of the growth on an annual basis, and the trust will not grow in value. Even though Liam has set up a Charitable Remainder Unitrust, the value of the trust will remain constant due to the withdrawal of the investment growth and Liam will receive a fixed income stream (that happens to be equal to the annual growth in the trust assets each year). Liam could have attained the same result using a CRAT with a 10% payout.

**EXAMPLE:** Using the facts in the example above, if Liam created a CRUT with a 5% income stream (5% of the annual value of the trust), and the trust assets are growing at 10% per year, half of the growth is retained in the trust. Each year, the trust increases in value, which increases the income payout that Liam receives. Over time, assuming that the Trust increases in value each year, Liam may receive more money over his lifetime using this approach than he would by mandating a distribution of all of the trust growth each year.

Setting up a CRT economically usually requires a substantial amount of capital. A good rule of thumb is that if the value of property transferred to the CRT will not be at least \$500,000 it may be better to consider other alternatives. Not only will there be setup costs for the CRT, but there will be trustee fees and administration costs, so there should be sufficient capital inside the trust to generate the income necessary to cover these expenses and still allow the trust to grow in value over time. An alternative for those with smaller amounts of capital may be the Pooled Income Fund (PIF).

A Pooled Income Fund is managed directly by a charitable organization that sells units to individuals who wish to get benefits similar to those available with CRTs. To “purchase” a participation unit in the PIF, a taxpayer must make an irrevocable contribution of property granting a vested remainder interest to the charitable organization. The property contributed is commingled with the property of other donors, and is invested by the charity. Interest and dividends earned on the portfolio of assets inside the PIF are distributed to the unit owners each year in proportion to their ownership interest in the pool of assets. Capital gains realized on the portfolio are considered capital, and are not available to be distributed to the unit holders, although the reinvested capital gains may increase income in future years. Unlike a CRT, which must be set up as an annuity trust or as a unitrust, a pooled income trust distributes the income of the trust to the unit holders on an annual basis (recall that if a CRT does this, it will lose all of the tax benefits associated with being a CRT). With a PIF, the donor must

retain a life income interest in the pool of assets; the donor may not make a contribution to the PIF in return for a term income interest.

Donors to PIFs are entitled to benefits similar to the benefits derived from CRTs. First, the present value of the remainder interest that is reserved for charity qualifies for an income tax charitable deduction. Second, contribution of appreciated property to a PIF avoid recognition of gain on the asset contributed. Finally, the income beneficiary of a PIF receives an income stream (in this case, a pro-rata share of the interest and dividends of the fund) for life.

There are a few special rules that apply to PIFs. No donor or income beneficiary of a pooled income fund may serve as trustee. As a practical matter, the management of most pooled income funds is farmed out to an asset manager since the charitable organization will not typically have the expertise to run the investment fund. When a CRT is created, the grantor, or any other person the grantor names, may serve as Trustee. PIFs are prohibited from investing in tax-exempt securities, while CRTs may invest in these instruments.

One additional form of partial interest charitable transfer is worth mentioning here. A Charitable Lead Trust (CLT) is the inverse of a CRT. A CLT distributes income to a charity for a period of years, and the remainder interest in the trust is transferred to a non-charitable beneficiary. While CLTs are used primarily to achieve estate planning benefits, there are also income tax consequences that are important for a financial planner to understand.

Unlike CRTs, there are no payout, term, or remainder value requirements that apply to CLTs. These requirements are applied to charitable remainder trusts to protect the charity's remainder interest. With a charitable lead trust, the charity gets the up-front interest, and the non-charity receives the remainder interest. The grantor of a CLT is likely to take steps to protect the interest of the remainder beneficiaries, so there is no need for the government to impose restrictions on the design of the trust.

Charitable lead trusts can be structured as either qualified CLTs or non-qualified CLTs. A Qualified CLT "qualifies" for the income tax charitable deduction. A non-qualified CLT does not generate an income tax charitable deduction for the donor.

To create a qualified CLT, the income interest that is distributed to the charity must be either an annuity (CLAT) or a unitrust (CLUT) interest. In addition, the qualified CLAT or CLUT must be a grantor trust. The grantor trust rules of the Code, found in Secs. 671-679, require the grantor of a trust to pay tax on trust income when grantor trust status is achieved. Therefore, in order to qualify for an income tax charitable deduction when creating a CLT, the donor must be willing to pay tax on the trust income during the term of the charitable income interest. A qualified CLT requires the grantor to make a tradeoff – the current income tax deduction is achieved at the cost of including all of the trust income in the donor's personal tax return during the charitable income term. When a donor is currently in a high income tax bracket, and expects to be

in a lower income tax bracket in the future, this tradeoff can result in a tax arbitrage. The charitable deduction is taken when the tax benefit will be the greatest, and the trust income will be included in the grantor's tax return when he or she is in a lower income tax bracket.

The problem associated with a qualified CLT – phantom income for the grantor during the charitable income term – can be avoided by creating a non-qualified CLT. Non-qualified CLTs do not qualify for a charitable income tax deduction, but the income of the CLT will not be included in the grantor's personal income tax return during the charitable income term. A non-qualified CLT can be created in one of two ways: (1) structuring the charitable income interest in a way that does not meet the definition of an annuity or unitrust payment; or (2) drafting the CLT to avoid the grantor trust rules.

While an itemized income tax charitable deduction (on Schedule A) will not be available for the grantor of a non-qualified CLT, the grantor of the trust does achieve a deduction, but in this case it is an above-the-line charitable deduction.

**EXAMPLE:** Ryan is a high income taxpayer, and has approximately \$100,000 in interest income that he pays tax on each year. Due to his high AGI, he is in the phaseout range for itemized deductions. Ryan is a board member of a local animal shelter, and the organization would like to build a new facility. Ryan would like to give \$100,000 per year for 5 years to the charity. If he simply writes a check each year to the charity for this amount, he will not be able to deduct the full amount as a charitable deduction due to the fact that he is in the phaseout range for itemized deductions. If Ryan contributes his income producing assets to a Charitable Lead Trust that will pay \$100,000 to the charity for five years, he can achieve his charitable objective while at the same time removing the \$100,000 from his income each year. Once the income producing assets are transferred to the trust, the trust will receive the income and will distribute it to the Charity, which is not subject to income taxes. For the next five years, Ryan will not have to report the \$100,000 on his income tax return. By removing the \$100,000 from his income, Ryan has achieved an above-the-line charitable deduction, reducing his AGI and potentially providing a benefit for other planning opportunities that are phased-out based on AGI limitations.

As mentioned earlier, the primary benefits associated with CLTs (the ability to shift growth on assets on a transfer-tax free basis) are related to estate planning, not income tax planning. Understanding the basic income tax issues associated with CLTs is important for planners to properly advise their clients on the planning options available to them.