Charitable Planning

CRTs, CLTs and the Increasing Payment CLAT

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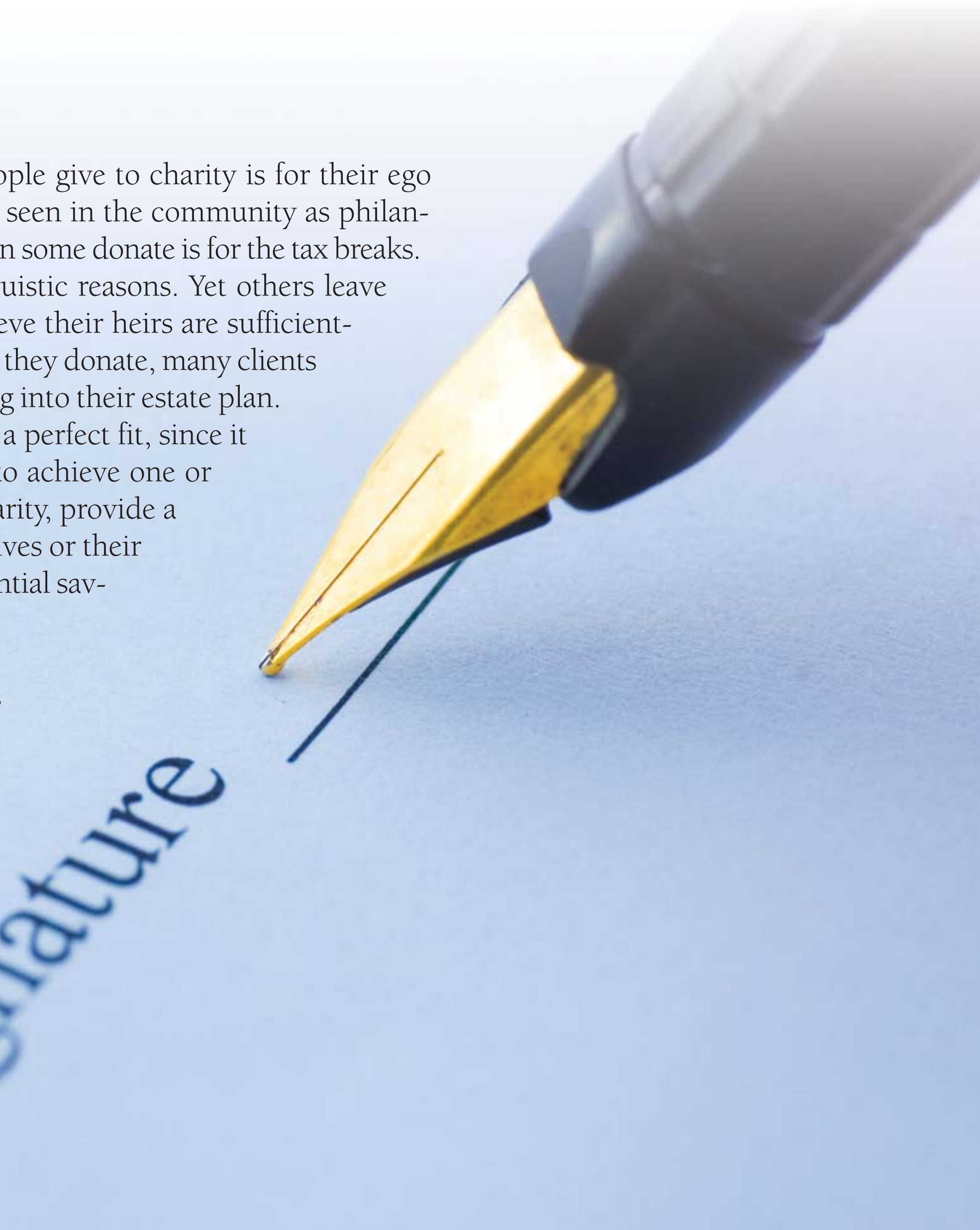

One of the main reasons people give to charity is for their ego or image—they want to be seen in the community as philanthropic. Another main reason some donate is for the tax breaks. Others give to charity for truly altruistic reasons. Yet others leave money to charity because they believe their heirs are sufficiently provided for. For whatever reason they donate, many clients want to incorporate charitable giving into their estate plan. For them, a charitable trust may be a perfect fit, since it can be an effective way for clients to achieve one or all of these goals: give money to charity, provide a limited monetary benefit to themselves or their heirs, and receive potentially substantial savings in income, estate or gift taxes.

The CPA adviser should be able to discuss not only which type of charitable trust is most suitable for clients but also should know these trusts' impact on income and transfer taxes (see Exhibit 1). This article discusses two main types of charitable trusts, charitable remainder trusts (CRTs) and charitable lead trusts (CLTs); describes the advantages of each; and discusses which to use and when, based on your clients' goals. This article also focuses on a relatively new planning device called the increasing payment charitable lead annuity trust (IPCLAT).

Charitable Remainder Trusts

A CRT provides an annual stream of payments to one or more noncharitable beneficiaries for a term of years with an irrevocable remainder interest to be transferred to charity. There are two types: the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT). A CRAT pays a fixed amount each year to the noncharitable beneficiaries, while the CRUT's annual payments are based on a fixed percentage of the fair market value (FMV) of the trust's assets, valued annually. In either case, the noncharitable beneficiaries could be the donor or the donor's spouse or children.

The Internal Revenue Code provides a number of statutory requirements for CRTs. For example, the annual annuity must be at least 5% but no more than 50% of the trust's assets. The trust's term may be fixed but can be no longer than 20 years, or it can be for the life of one or more noncharitable beneficiaries. A CRUT may provide for payment of the lesser of a fixed percentage of assets or the trust's income ("income only" CRUT). A CRUT can also provide net income only with a makeup provision. This type of trust, called a "NIMCRUT," provides that if the trust income falls below the fixed percentage in one year, it can be made up in later years.

Key Attributes of a CRT

One of the key benefits of a CRT is its tax-exempt status; it is not subject to income tax at the trust level. Often, an important goal for the client is to transfer low-basis assets, sell the stock and either not recognize or defer the gain. Because of its tax-exempt status, a CRT meets this goal. If low-basis assets are transferred to the trust and sold, no income tax is due on the sale. This makes a CRT an excellent device for asset diversification. The trustee can sell trust assets and reinvest in a more diversified portfolio or higher-yielding assets. Thus, the CRT can work to increase cash flow to the donor or his or her heirs during the trust term. Note that even though the trust is not currently taxed on the trust income, the beneficiaries will pay tax on the portion of the trust's taxable income included in their distribution. The character of the income will be based on a tiered system. Generally, distributions are taxed in the following order: (1) ordinary income, (2) capital gains, (3) other income (including tax-exempt income) and (4) corpus.

Another key attribute is that the donor receives an income tax and gift tax charitable deduction in the year of contribution. The deduction is based on the actuarial value of the remainder interest. For income tax planning purposes, this makes a CRT an excellent tool to generate an income tax deduction. This could be especially beneficial in the year that the

Exhibit 1 Types of Trusts

CRT	Charitable Remainder Trust	Pays amounts to noncharitable beneficiaries and a remainder to charitable beneficiaries.
CRAT	Charitable Remainder Annuity Trust	A CRT that pays a fixed amount each year to noncharitable beneficiaries.
CRUT	Charitable Remainder Unitrust	A CRT that pays a fixed percentage of the FMV of the trust's assets to noncharitable beneficiaries.
NIMCRUT	Net Income with Makeup CRUT	A CRUT whose payments to noncharitable beneficiaries can be made up in a future year if its income falls below its percentage payout in one year.
CLT	Charitable Lead Trust	Pays an annuity to charitable beneficiaries and the remainder to noncharitable beneficiaries.
CLAT	Charitable Lead Annuity Trust	A CLT that pays a fixed amount each year to charitable beneficiaries.
CLUT	Charitable Lead Unitrust	A CLT that pays a fixed percentage of the FMV of the trust's assets to charitable beneficiaries.
IPCLAT	Increasing Payment CLAT	Provides an annuity (initially a fixed amount or percentage) that increases during the annuity period.

donor has unusually high income, such as the year of a Roth IRA conversion. Like all contributions to charity, this upfront charitable income tax deduction is limited to 50% of adjusted gross income (AGI) for gifts of cash, 30% of AGI for gifts of long-term capital gain property, and 20% of AGI for gifts of long-term capital gain property to a private foundation. A CRT set up at death would similarly receive a charitable estate tax deduction. However, no income tax deduction is available in the case of a testamentary (established by a will) CRT.

Who should use a CRT?

1. A client who wants to retain an income interest or give this interest to a spouse or heirs. This could be used to cover a current financial need or be used to purchase insurance on the donor's life, for example.
2. A client who has low-basis, highly appreciated assets and wants to diversify. Since the CRT is tax-exempt, it will not recognize gain on the sale of the asset. Therefore, a CRT is often used to increase cash flow by selling the asset and reinvesting into a higher-yielding investment. This could be used to fund the annuity or unitrust payment.
3. A client who wants to reduce estate taxes. For estate planning purposes, the client could set up a testamentary CRT or even name a CRT as the beneficiary of a retirement plan. Unlike an inter vivos (established during the donor's lifetime) CRT, no income tax deduction is allowed, and there is no gift treatment for any interest passing to noncharitable beneficiaries. However, the estate does get a charitable deduction equal to the fair market value of the CRT's remainder interest.
4. A client who wants to retain ultimate control of the assets. A donor can serve as sole trustee. However, to protect the integrity of the CRT, it is recommended that the trustee obtain a qualified appraisal of the trust's assets annually.

As mentioned, because the trust is tax-exempt, great assets to transfer to a CRT include low-basis, highly appreciated assets such as marketable securities, C corporation stock and unencumbered real estate. The following assets should not be used to fund a CRT:

a. Assets the trustee is obligated to sell. The IRS could treat this as if an asset were sold and cash donated to the trust.
b. Tax-exempt securities.
c. S corporation stock, since a CRT is not an eligible S corporation shareholder.
d. Partnership interests, including publicly traded partnerships, since there is potential for unrelated business taxable income (UBTI), which could cause all of the CRT's income to be taxable for the year.
e. The donor's personal residence, since living there is an act of self-dealing.
f. Encumbered real estate.
g. Tangible personal property.
h. Stock options.

Charitable Lead Trusts

A charitable lead trust (CLT) is the mirror image of a CRT. It provides that the annual annuity stream (lead interest) is to be paid to a qualified charity and the remainder interest is to be paid to the donor or the donor's spouse or heirs. Unlike a CRT, a CLT is not tax-exempt. Trust income is taxed like the income of any other complex or grantor trust, as the case may be. Unlike a CRT, (1) there is no requirement the annuity be at least 5% or not more than 50% of the trust's assets; (2) the guaranteed annuity can be based on a life interest plus a term, in which case the guaranteed annuity is redetermined at the expiration of the term; and (3) there is no such thing as an income-only CLT—principal must be used to pay the charitable lead interest if income is insufficient.

There are two main types: a grantor CLT and a nongrantor CLT. There is also a charitable income trust, also called a nonqualifying, nongrantor CLT, which is beyond the scope of this article. Each trust accomplishes different objectives.

EXECUTIVE SUMMARY

■ **Charitable trusts offer taxpayers an opportunity to support philanthropic causes** while providing benefits to themselves or their heirs and saving income, estate or gift taxes. CPAs can advise clients on the type of charitable trust that best suits their goals and characteristics.

■ **A charitable remainder trust (CRT) provides an annuity to noncharitable beneficiaries** for a term of years, either as a fixed amount (charitable remainder annuity trust, or CRAT) or percentage of assets (charitable remainder unitrust, or CRUT) and the remainder to a charitable beneficiary. Two key advantages of a CRT are a current charitable deduction for the donor of the actuarial value of the remainder interest and its ability to hold and sell certain low-basis, highly appreciated assets donated by the client.

■ **A charitable lead trust (CLT) provides an annuity to a charitable beneficiary** and a remainder to the donor or the donor's spouse or heirs. A key advantage is its potential for savings on gift taxes and either a charitable deduction for the donor (grantor CLT) or payment of income tax by the trust rather than by the donor (nongrantor CLT).

■ **A relatively new form of CLT is the increasing payment charitable lead annuity trust (IPCLAT).** As the name implies, it can provide a steadily increasing annuity with or without a "balloon" payment, to time distributions optimally for investing outlook and client goals.

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A grantor CLT, like a CRT, is designed to give the donor an upfront charitable income tax deduction. However, to receive the charitable income tax deduction, the donor must be willing to be taxed on all trust income. After all, it is a grantor trust. In addition to paying the tax each year, the donor must be willing to give up the cash flow during the trust's term. Also note that the income tax deduction is limited to 30% of AGI (even for gifts of cash), since the gift is "for the use of" rather than "to" the charitable donee. Furthermore, the 20% limitation applies if the trust is funded with long-term capital gain property and the donee is not a public charity. Unused deductions in one year can be carried over to the next five succeeding years.

It might seem that low-basis, highly appreciated assets would be best contributed to a CRT or nongrantor CLT. However, they still may be appropriate assets to transfer to a grantor CLT for at least several reasons, even though the grantor will be immediately taxed on the gain. First, this gain would go into AGI, increasing the amount of the deduction just created by setting up the grantor CLT. The donor would be taxed on the gain anyway if the assets were sold outside the trust. Second, if the donor can get a low valuation on the asset (such as closely held stock) on the date of the gift and the asset does experience exponential growth and is sold at a later date, more assets will be going to heirs at a lower gift tax cost, since the lead interest is based on the initially discounted or low-valued asset.

However, keep in mind when setting up the trust term that the donor must "recapture" some of the income tax charitable deduction if he or she dies during the trust term.

Because of the taxation of a grantor CLT, it is most often used in income tax planning rather than estate tax planning. However, in a low-interest-rate environment, to the extent the assets can grow faster than the IRC § 7520 rate (tables for valuing the remainder interest), more assets will pass to heirs at the end of the trust term at a lower gift tax cost.

With a nongrantor CLT, the grantor does not receive the upfront charitable income tax deduction. However, he or she is not taxed on the income of the trust. Instead, the trust pays tax on the income, and the trust claims a charitable deduction for the amounts it pays charity. In other words, it is taxed like a typical complex trust. A nongrantor CLT can be inter vivos or testamentary. A testamentary CLT receives the estate tax deduction but no income tax deduction.

Whether the trust is a grantor or nongrantor CLT, because the trust is not tax-exempt, the ability to avoid or defer tax on the sale of low-basis appreciated assets does not exist as with a CRT. In either case, the donor removes the asset and future appreciation from his or her estate and receives a gift or estate tax charitable deduction.

Who should use a CLT?

1. Wealthy clients who want to utilize the current charitable deduction to reduce taxes (for example, in a year with unusually high AGI) should use a grantor CLT but only if they are willing to pay tax on all trust income.
2. Clients who don't want to give up control of the assets just yet but still want the benefits of the tax deductions.
3. Clients who are willing to forgo current cash flow and whose heirs can wait until the end of the trust term to receive the assets (possibly to meet a dependent's future needs).
4. Clients who want to take advantage of a low-interest-rate environment, since the lead or charitable income interest is given a higher value when the section 7520 rate is low. To the extent the asset can grow faster than the section 7520 rate, more assets will inure to the donor's heirs at a lower gift tax cost.
5. Clients who want to reduce estate and gift taxes. Since the gift or estate tax value is determined based on the date the trust is funded, all future appreciation escapes estate and gift taxation.
6. In all cases, clients who want to make gifts of assets that currently have a low or discounted value but that the client expects will appreciate significantly in the future. With an inter vivos CLT, however, the donor must be willing to forgo the possibility of a step-up of basis at the date of death. Any assets remaining in the trust will take a carryover basis (rather than a stepped-up basis, which would occur at death). The loss of the basis step-up should be considered before placing the asset in the trust. If the asset will be sold during the trust term, this may not be a factor.

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An Excel spreadsheet illustrating an "increasing payment charitable lead annuity trust," or IPCLAT, is available with the online version of this article at **tinyurl.com/33mjxaf**.

Increasing Payment CLAT

As stated above, one of the requirements of a CLT is that it must pay either a fixed-dollar amount (CLAT) or a fixed percentage of the initial FMV (CLUT) to charity. However, unlike a CRT, there is no requirement that the CLT annuity be at least 5% or no more than 50% of the trust's assets. In fact, there is no requirement that this annuity be the same amount or percentage every year. In Revenue Procedure 2007-45 (in which the IRS set out sample forms for CLTs), the IRS stated that "the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded." Thus, the "increasing payment charitable lead annuity trust," or IPCLAT, was born. An inter vivos IPCLAT can be grantor or nongrantor. Fixed payments may be sufficient in some situations. (An Excel spreadsheet accompanying this article at **journalofaccountancy.com** demonstrates the following calculations; enter 20102678 in the search box to find the article.)

Take, for example, a donor who wants to set up a 10-year CLAT and zero out the gift to the remainder beneficiaries (see the spreadsheet tab “Fixed”). Assuming a section 7520 rate of 3.4% (May 2010), this donor could set up a 10-year CLAT with a steady annuity of $598,179 per year. In other words, a contribution of $5 million to the CLAT would provide a $5 million income tax deduction and a zero taxable gift. Assuming an after-tax growth rate of 6%, $1,069,762 would be left in the trust at the end of the trust term to be distributed to beneficiaries.

However, there are significant economic reasons a donor would want to structure a CLT to provide for increasing payments. A CLT with lower distributions to charity in the early years allows for more upfront growth and accumulation of assets over the term of the trust—especially in a down or volatile market. Assume the same facts as before, except that the donor wants to increase the annual annuity by 20% each year (see the spreadsheet tab “20%”). To zero out the gift, the trust would pay a first-year annuity of $241,837 with the annuity increasing by 20% every year. If, at the end of the trust term, the after-tax growth rate were 6%, $1,352,118 would be left in the trust to be distributed to heirs, with $6,277,765 in total payments to charity.

Now assume the client wants an even more aggressive alternative because the client is afraid the market may be in a downturn during the early years and wants to grow the assets as much as possible in the trust before making distributions. In this case, the client would set up a CLAT that provides for minimal payments to charity for the first nine years and then a balloon payment at the end of year 10 (the “balloon IPCLAT”). This type of arrangement would allow for significantly higher appreciation in the early years, since little or no assets are being distributed out of the trust to charity. Whether the assets perform well or not in the early years, the trust retains more assets for reinvestment. At the end of the trust term, because of the upfront growth of the assets in the trust, more assets should be going to heirs.

Assume that this trust provides for a $1 annual payment in years 1 through 9 and a balloon payment of $6,985,134 in year 10 (see spreadsheet tab “End”). This same trust with 6% growth would yield $1,969,092 to heirs at the end of the 10-year term—an 84% increase in assets to be distributed to heirs over the constant-rate IPCLAT in the previous example.

If this donor makes the IPCLAT a grantor trust, he or she will pay taxes on all trust income, but he or she will also receive a $5 million charitable income tax deduction. In addition, $6,985,143 will be transferred to charity during the trust term, $1,969,092 will be transferred to heirs after 10 years, and the donor will incur no gift or estate tax costs. On the other hand, for nongrantor IPCLATs, keep in mind that the trust itself is taxed on income and capital gains and receives a deduction for amounts paid to charity. If the charitable balloon payment is deferred until the final year, this would limit the trust’s ability to take the deduction.

Caution: The CPA adviser should note that, although the IRS has stated in Revenue Procedure 2007-45 that CLTs can have increasing annuity payments, the Service has not specifically opined on a strategy like the balloon IPCLAT. Could it be considered abusive? Should the annual growth of the annuity be limited to 20% like CRTs? In any case, some planners may think that the balloon IPCLAT is too aggressive and may advise their clients to limit the annuity payments to a 20% annual increase.

Final Note

With this type of planning, the client must certainly have charitable inclinations. Furthermore, as with all planning, there are many uncertainties that even the best plan cannot overcome: the volatility and uncertainty of the stock market (if assets lose money, there may be nothing left to the heirs); estate and gift tax rates (for example, as of this writing, clients dying in 2010 pay no estate tax, but their heirs are subject to a modified carryover basis regime); timing of death; and income tax rates, among others. The CPA adviser can only advise the client of the best estate and income tax planning moves, given current or foreseeable conditions. Above all, the CPA planner should have many options available in his or her arsenal to provide the best advice for clients. ❖

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