The Relevance of Charitable Trusts in 2019 and Beyond

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The Tax Cuts and Jobs Act, signed into law on December 22, 2017, by President Trump (the "Act"), nearly doubled the federal estate and gift tax exemptions for individuals, increasing the exemption from $5.49 million per individual in 2017 to $11.4 million in 2019, to be indexed for inflation each year. Our clients can now either gift during their lifetimes or leave to a non-spouse at their death $11.4 million in assets, and for our married clients, they can structure their estate plan to leave $22.8 million with no imposition of gift or estate taxes. Even if the Act sunsets at the end of 2025, resulting in the exemptions reverting back to $5 million per person (indexed for inflation), most of our clients will have no gift or estate tax concerns. In the past, we would structure large gifts to trusts in such a way that would minimize the gift and estate tax consequences and still provide for the client's descendants as well as charities. Now, we can continue these split interest gifts to trusts for our clients, for the most part without regard to triggering any gift tax liability. Charitable trusts remain relevant in this age of large gift and estate tax exemptions and with the tax planning focus shifting from estate and gift tax savings to income tax savings, certain charitable trusts can be structured to provide the donor with immediate income tax deductions. The focus of this article is how to incorporate charitable giving in our clients' estate plans by utilizing various split interest trusts and how the Act may impact which particular trust instruments we should recommend.

CHARITABLE SPLIT INTEREST TRUSTS

What are charitable split interest trusts? Put simply, these are trusts that benefit both charitable and non-charitable beneficiaries. Clients have two main options, the charitable lead trust or the charitable remainder trust.

The Charitable Lead Trust

Charitable lead trusts (herein "Lead Trusts") provide income payments to at least one qualified charitable organization for a period measured either by (i) a term of years, (ii) the lifetime of one or more individuals, or (iii) the lifetime of an individual followed by a term of years. At the end of the trust term, the remainder is paid to one or more non-charitable beneficiaries, usually the donor's children and/or grandchildren.

Lead Trusts are traditionally structured as non-grantor trusts, meaning that the donor does not receive a charitable donation deduction for income tax purposes. However, the income generated within the trust during the trust term is not taxable to the donor. Historically, the most common type of Lead Trust was a charitable lead annuity trust (CLAT). CLATs are exceedingly more popular in low interest rate environments because the goal over the trust term is for the trust investments to outperform the low interest rate fixed as of the trust's inception, so that ultimately, more is left to the donor's children gift and estate tax free. Additionally, the lower the interest rate used at the trust inception, the lower the calculated value of the remainder interest for gift tax purposes. When gift and estate tax exemptions were low, we would try to create a "zeroed out CLAT," meaning that it would be structured so that the remainder valuation would equal zero so that no gift tax exemption was being used up. Practically, however, the goal was that over the long term, the trust investments would leave available assets in the trust at the end of the term, which would pass to the donor's descendants. Because the calculations for gift tax purposes happen at the trust's inception without regard to actual investment performance, this technique was very popular. With $11.4 million of gift and estate tax exemption, however, we can create shorter Lead Trust terms and even look to using more intentionally defective grantor trust (herein "grantor trusts") structures to allow for charitable income tax deductions to the donor.

When structured as grantor trusts, the Lead Trust can provide a charitable donation income tax deduction to the donor, which is calculated at the creation of the trust based on the interest rates in effect when the trust is funded. Because we aren't as concerned any longer with minimizing the taxable gift to the remainder beneficiaries, a client can now consider utilizing a Lead Trust primarily to achieve a front loaded charitable income tax deduction. Because estate and financial planning has taken a significant shift from saving estate taxes to saving income taxes, grantor Lead Trusts are much more relevant today than ever before. Consider the following examples:

- Donor, age 65, transfers $100,000.00 to a Lead Trust, which provides for a 5-year term during which period 10% is paid out to charitable beneficiaries each year. If structured as a grantor charitable lead annuity trust (CLAT) the calculations would be as follows:
    - Donor receives an income tax deduction of **$45,797.00** (based on IRC §7520 discount rate of 3%)
    - Annual payout to charities is $10,000.00
    - Donor pays income taxes during the 5-year term on any income earned by the trust
    - The balance remaining after the 5-year term is then distributed to Donor's designated beneficiaries, which can even include the Donor

- Same facts as above except that instead of a 5-year term, Donor creates a grantor CLAT based on his life expectancy. Donor's income tax deduction would now increase to **$88,617.00**. This scenario allows the Donor to benefit a charity or charities over time while still receiving the upfront deduction and allowing for the possibility that some of this money will end up being left over for Donor's family at the end of the trust term.

- Same facts as above (term based on Donor's lifetime) but instead the trust is structured as a charitable lead unitrust (CLUT), where the payout is recalculated each year based on the value of the trust corpus. In this example, the deduction reduces to **$76,046.00**.

Despite the recent hikes in interest rates by the Federal Reserve, interest rates are still historically low. Because low interest rates provide for a higher calculated annuity interest and thus the amount of the available charitable income tax deduction, we are still in an environment where grantor Lead Trusts are very attractive for certain clients. We can structure these trusts where the grantor/donor is the remainder beneficiary once the charitable term ends, thus allowing the donor to effectively front load their charitable donation deduction for the year in which a larger taxable event may have occurred, such as the sale of a business or highly appreciated asset. There are many variations these trusts can take and, because they are not regulated to the extremes of charitable remainder trusts (discussed below), Lead Trusts can be drafted to suit the needs of clients in all different stages of life.

Charitable Remainder Trusts

Charitable remainder trusts (herein "Remainder Trusts") are the reverse of Lead Trusts and provide payments to one or more non-charitable beneficiaries at least annually for a specified term with the remainder paid upon termination of the trust term to one or more charitable beneficiaries. Most Remainder Trusts are structured to provide the donor with a charitable contribution deduction upon creation of the trust, which deduction will equal the present value of the remainder interest passing to the charity. Unlike Lead Trusts, Remainder Trusts are more popular in higher interest rate environments because the higher the interest rate, the higher the present value of the remainder interest and thus the greater the charitable income tax deduction. With interest rates projected to increase this year and to continue to increase for the foreseeable future, discussions of Remainder Trusts will become more popular.

Remainder Trusts are highly regulated by the Treasury Department as they are treated in part as if they are exempt organizations and, in fact, are exempt from all taxes unless the trust has unrelated business taxable income (UBTI). They are governed by private foundation rules that tax UBTI at a 100% excise tax on any such income. However, UBTI generally excludes investment income[i] (dividends, interest, rent from real property, royalties and annuities). Because they are treated like an exempt organization, Remainder Trusts are NOT subject to Medicare surtax; however, distributions to non-charitable beneficiaries during the annuity term of the trust can be subject to the surtax on the individual beneficiary's personal tax return.

The Medicare surtax, also known as the Net Investment Income Tax, is a tax imposed on higher income earners and is levied on a taxpayer's net investment income. What is Net Investment Income? Generally, net investment income will include (but is not limited to) interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer. Because these trusts are not subject to the Medicare surtax, a donor who contributes appreciated property to a Remainder Trust which is later sold by the trust can avoid this surtax being applied to the capital gain. The proceeds, of course, would all be reinvested within the trust. However, only portions of such capital gain may end up being distributed to the trust's individual beneficiaries, and it is more likely in this scenario that the amount distributed would not kick that beneficiary into the income levels at which the surtax would apply.[ii] For our clients who have charitable goals, we can recommend donations of assets producing income that would otherwise result in this surtax being levied at their individual tax level to Remainder Trusts. Keep in mind, however, that appreciated property contributed to a Remainder Trust will limit the donor's charitable donation deduction to 30% of their adjusted gross income.

Remainder Trusts have many technical requirements, including the following:

- 5% minimum/50% maximum payout/annuity rate

- 10% minimum present value of remainder interest requirement (based on initial value of transferred property)

- Mandatory Provision to Name Alternate Remainderman
    - The trust must contain a provision that, in the event the named charitable remainderman does not exist or shall for some reason fail to qualify as a charitable organization, an alternate qualified organization must be chosen by either the donor or the trustee
    - Notwithstanding the above requirement, the IRS has ruled that the donor/grantor can retain a power to substitute the named charitable remainderman with another qualified organization. (Inclusion of this power limits the donor's deduction to 30% of AGI.)

    - Also, the trustee and any income beneficiaries can be given this power of substitution

- Two main types of Remainder Trusts allowed, annuity trusts (CRATs) and unitrusts (CRUTs)
    - No blending allowed
    - Trust must be either a CRAT or CRUT in every respect
    - Principle difference is how income distributions are determined

- Charitable Remainder Annuity Trusts (CRATs)
    - Required distribution of at least 5% of initial value of trust assets not less than annually to one or more non-charitable beneficiaries.
    - Distribution can be a fixed sum or a fixed percentage of initial value of trust assets. However, once fixed, sum or percentage cannot change.
    - Term can be based on a term of years (not more than 20) or on a measuring life or lives of an individual living on date of creation of trust.
    - **No additional contributions are allowed.**
    - If a Donor were to transfer $100,000.00 to a 5-year CRAT with a 10% payout rate, the Donor's charitable deduction in the year of the gift would equal $53,921.00 (based on a 3.2% IRC §7520 discount rate).[iii]

- Charitable Remainder Unitrusts (CRUTs)
    - Required distribution of a fixed percentage of at least 5% of the value of trust assets (determined on an annual basis) and distributed at least annually to one or more non-charitable beneficiaries.
    - Distribution term can be for a term of years or based on a measuring life or lives of an individual living at trust creation.
    - **Additional contributions are permitted.**
    - If a Donor where to transfer $100,000.00 to a 5-year CRUT with a 10% payout rate, the Donor's charitable deduction in the year of the gift would equal $59,690.00 (based on a 3.2% IRC §7520 discount rate).[iii]

Luckily, the IRS has released various sample Remainder Trust documents, which are sanctioned for use by practitioners and it has stated that it will continue to issue rulings to taxpayers who request whether or not specific provisions in the taxpayer's proposed trust which deviates from the sample documents will result in the disallowance of a charitable deduction. The IRS will not, however, continue to issue advance rulings stating whether a transfer to a Remainder Trust providing either annuity or unitrust payments for one or two measuring lives qualifies for charitable income, gift or estate tax deductions.

CONCLUSION

Early data has been released showing that overall charitable giving increased by a total of 1.5% in 2018[iv] over the prior year, despite many predictions to the contrary. Americans continue to give generously and, as advisors, it is imperative that we educate our clients on the best giving techniques for their particular situation. Charitable trusts remain relevant even with the much larger estate and gift tax exemptions put in place by the Tax Cuts and Jobs Act and can be structured to allow taxpayers to provide for their family, meet charitable objectives and benefit from a charitable income tax deduction.

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[i] The IRS has ruled that investment income is taxable as UBTI where (i) trust incurred a debt to make the investment producing the income; and (ii) if trust receives income from a controlled subsidiary. If a Remainder Trust holds a partnership interest and the partnership engages in an activity that would be considered unrelated business if engaged in by the Remainder Trust then the trust must include in UBTI its share of the partnership's income from the unrelated activity.

[ii] The Medicare surtax applies to the following modified adjusted gross income levels for 2019: MFJ-$250,000.00, MFS- $125,000.00, All other filing types-$200,000.00.

[iii] Estimated charitable deductions in examples provided by ALSAC/St. Jude Children's Research Hospital for illustrative purposes only.

[iv] See the Blackbaud Institute's 2018 Charitable Giving Report.

The information in this white paper does not constitute legal, tax, or financial advice.