Charitable Remainder and Charitable Lead Trusts

In brief

CHARITABLE SPLIT-INTEREST TRUSTS

Charitable remainder trusts and charitable lead trusts are split-interest charitable trusts: they are set up to benefit both charitable beneficiaries and individual beneficiaries. As their names indicate, the two types of trusts differ in timing: the charitable remainder trust (CRT) benefits the charity last, and the charitable lead trust (CLT) benefits the charity first. The two trusts also serve very different purposes, and the donor's goals, income needs, and assets should be examined when considering and comparing these trust strategies.

Charitable Remainder Trust

- Allows the donor to provide a gift to charity (i.e., the remainder interest) while reserving an income stream personally or for any other non-charitable beneficiary.
- If the donor creates and funds the trust during his or her lifetime, the donor receives a current charitable income tax deduction for the present value of the remainder interest passing to charity at the end of the trust term.
- In most situations, the property is not subject to tax in the donor's estate.
- The CRT can sell appreciated property without currently recognizing gain, allowing the trust to reinvest the entire sale proceeds.
- Higher interest rates are optimal for a donor using a CRT as an estate planning technique.

Charitable Lead Trust

- Allows the donor to provide a gift to charity (i.e., the lead interest) while naming himself or herself or someone else (such as family members) as the remainder beneficiary.
- In some situations, the donor receives a current charitable income tax deduction.
- For gift or estate tax purposes, the value of the property transferred to the trust is reduced by the value of the charitable lead interest.
- Certain types of CLTs can be effective ways to preserve the contributed assets for future generations.
- Lower interest rates are optimal for a donor using a CLT as an estate planning technique.

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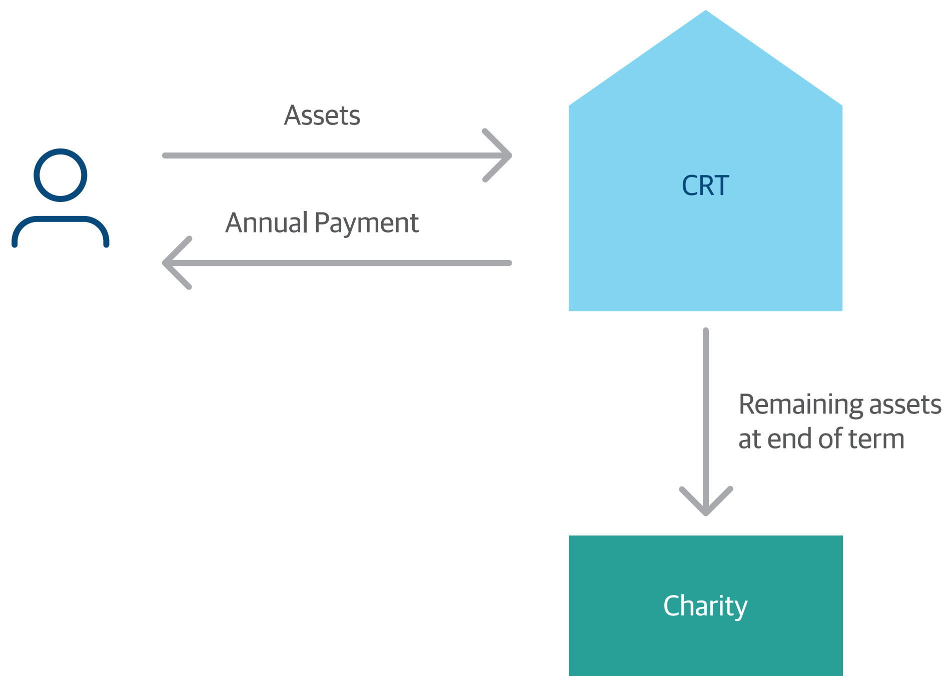
CHARITABLE REMAINDER TRUSTS



CRT mechanics

- Donor creates an irrevocable charitable remainder trust. The CRT can be funded during the donor's lifetime or at the donor's death. Either the donor or the donor's designated beneficiaries receive annual payments from the CRT for a specified term of years (no more than 20 years) or for life.
- The CRT must make payments at least annually, and at least one income beneficiary must not be a charity.
- The CRT can either be an annuity trust or a unitrust.
  - A charitable remainder annuity trust (CRAT) pays a fixed amount, either as a dollar amount or as a percentage (not less than 5%, not more than 50%) of the initial fair market value of the CRT assets.
  - A charitable remainder unitrust (CRUT) pays a fixed percentage (not less than 5%, not more than 50%) of the CRT assets valued annually.
- Additional contributions may be made to a unitrust but not to an annuity trust.
- At the expiration of the non-charitable term of the trust, the remainder must be paid to the charity or charities designated in the CRT document. The donor may reserve the right to change the charitable remainder beneficiaries.

CRT income tax consequences

- Donor receives a current income tax charitable deduction equal to the present value of the remainder interest passing to charity. Treas. Reg. § 1.664-4(a). The donor's income tax charitable deduction is subject to the same percentage limitations as outright charitable contributions. The present value of the charitable interest must be at least 10% of the initial value of each gift to the CRT.
- CRTs are tax-exempt trusts. Internal Revenue Code (I.R.C.) § 664(c).
- A CRT can sell appreciated property without incurring an income tax. When assets are sold in a CRT, the income tax consequences to the donor are generally deferred, not avoided. CRT distributions are taxed to the donor or other non-charitable beneficiaries to the extent the trust has income in the current year or undistributed income from prior years. Distributions are taxed to the income beneficiaries in the following order: ordinary income (including short-term capital gain), long-term capital gain, tax-exempt income, and return of principal. I.R.C. § 664(b).

CRT gift tax consequences

- Donor receives a gift tax charitable deduction for the present value of the remainder interest. I.R.C. § 2522(c)(2)(A).
- If the donor creates an income interest in a non-charitable beneficiary other than the donor or donor's spouse, there is a taxable gift. If the non-charitable beneficiary has a current income interest, that is a gift of a present interest which can qualify for the gift tax annual exclusion.
- If the non-charitable beneficiary's interest begins in the future, the donor may retain the right to revoke the beneficiary's interest. In this case, there is no current gift.

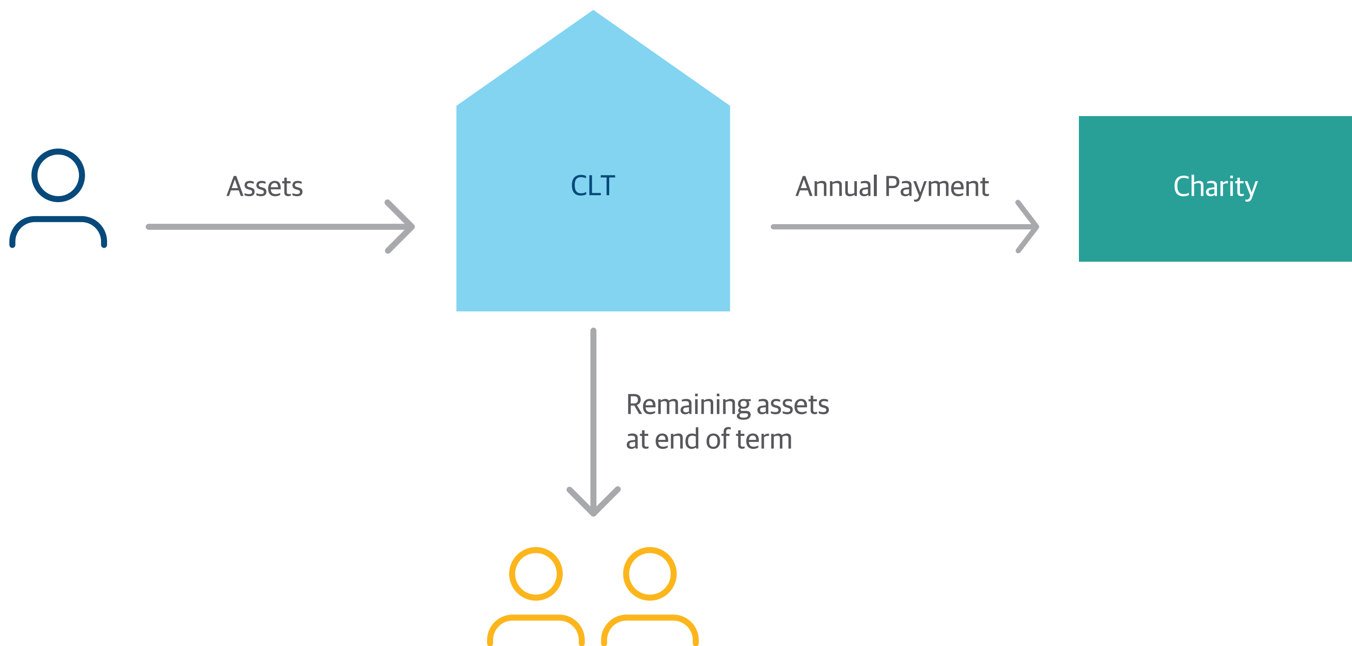
CRT estate tax consequences

- The CRT value is included in the donor's gross estate if the right to receive an amount from the CRT existed at death or was relinquished within three years of death. This inclusion will be offset, at least partially, by the estate tax charitable deduction for the value passing to charity. I.R.C. § 2055(e)(2)(A).

CRT planning strategies

- **Life Insurance in a Wealth Replacement Trust –** The donor may use all or part of the annual payment received from the CRT to fund life insurance in a wealth replacement trust. For the donor's heirs, the life insurance proceeds in this trust replace the remainder assets left to charity. If the donor is receiving annual CRT payments for life, this strategy hedges against the risk of the donor dying earlier than expected and receiving fewer annual payments than expected.
- **Minimizing taxes on retirement accounts using a CRT at death –** IRA or qualified plan assets cannot be directly transferred to a CRT during the donor's lifetime. However, for an individual with large, taxable retirement accounts, leaving a portion of the retirement accounts to a CRT at death could be a good income tax deferral strategy. A CRT could allow annual CRT payments to be spread out over a period greater than the 10-year RMD period required for most non-spouse beneficiaries.
- **Taking the income tax deduction in an itemizing year –** The donor receives a current income tax deduction equal to the present value of the remainder interest passing to charity (subject to normal deduction limitations based on a percentage of the donor's adjusted gross income (AGI)). An individual who normally takes the standard deduction could time the creation of a CRT for a year he or she plans to itemize.

CHARITABLE LEAD TRUSTS



CLT mechanics

- Donor creates an irrevocable charitable lead trust (CLT). The CLT can be funded during the donor's lifetime or at the donor's death. The CLT must make a payment (i.e., the lead interest) at least annually to the designated charity or charities for a specified term.
- The CLT can either be an annuity trust or a unitrust.
  - A charitable lead annuity trust (CLAT) pays a fixed amount, either a dollar amount or a fixed percentage of the initial fair market value of the CLT assets.
  - A charitable lead unitrust (CLUT) pays a fixed percentage of the CLT assets valued annually. Unlike the CRT, there is no minimum or maximum percentage that must be distributed annually.
- The payment period may be for a specific term of years or for the life or lives of an individual or individuals who are living and known on the date of the transfer. Unlike the CRT, there is no term limit for a CLT.
- At the expiration of the charitable payment period, the remainder interest is paid to either the donor or other non-charitable beneficiaries.

CLT income tax consequences

- Unlike CRTs, CLTs are not tax-exempt. A CLT can be designed as either a grantor trust or a non-grantor trust.
- If the CLT is a grantor trust, the donor receives an income tax charitable deduction equal to the value of the charitable lead interest (computed based on the IRS valuation tables) upon the creation of the trust. I.R.C. § 170(f)(2)(B). The charitable deduction is limited to 30% of the donor's AGI (or in the case of the donation of appreciated assets, 20%). The donor is taxed on all income as it is earned by the trust under the grantor trust rules.
- If the CLT is a non-grantor trust, the donor does not receive an income tax charitable deduction upon the creation of the trust. As a separate tax-paying entity, the CLT is taxed on all net income as it is earned by the trust. The CLT is allowed an income tax charitable deduction for amounts paid to charity each year. I.R.C. § 642(c)(1). The CLT's deduction is not subject to the percentage limitations that apply to charitable contributions from individuals.

CLT gift tax consequences

- Donor receives a gift tax charitable deduction for the value of the charitable lead interest. I.R.C. § 2522(c)(2)(B).
- There is a taxable gift if the remainder beneficiary of a CLT is someone other than the grantor.
- The gift of the remainder interest to a non-charitable beneficiary is a gift of a future interest and does not qualify for the gift tax annual exclusion.

CLT estate tax consequences

- In general, nothing is included in the donor's estate if the CLT is created during the donor's lifetime. If the intent is for the CLT to be a grantor trust, this can be done by using one of the grantor trust provisions of I.R.C. §§ 671-679 that do not cause estate inclusion.
- If the CLT is created upon the donor's death, the trust assets are included in his or her gross estate. The estate is entitled to an estate tax charitable deduction for the value of the charitable lead interest.

CLT planning strategies

- **Leveraging generation-skipping transfer (GST) tax exemption with a CLUT –** A CLUT that ultimately distributes to grandchildren or more remote descendants is a generation skipping trust. The amount of GST tax exemption which must be allocated is based on the value of the assets on the date of contribution less the charitable gift or estate tax deduction.
- **Using discounted property to fund a CLT –** Transferring assets to a CLT freezes their value for transfer tax purposes. If the donor can apply valuation discounts, such as a minority interest discount and/or a lack of marketability discount, this could produce savings by proportionately reducing the taxable value of the remainder interest.

COMPARING CRTS AND CLTS

While both trusts start with a donor who has some charitable intent, CRTs and CLTs are appropriate in different situations. An individual who creates a CLT must be comfortable losing the income from the transferred assets; so, if keeping an income stream is important, then a CRT is more appropriate. A CLT is useful for a donor who wishes to keep an asset in the family while saving on gift or estate tax cost.

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