Charitable Giving

Gifts to charitable remainder trusts can provide tax benefits for donors.

By Robert Ahearn, JD, LL.M., CFP, ChFC, CLU, CRPC

A charitable remainder trust (CRT) is a popular tax-advantaged strategy to convert highly appreciated assets into an income stream, while locking in a future contribution to the donor's preferred charity. Assets contributed to a CRT generate a current income tax deduction to the donor, based on the discounted value of the future gift to charity. The size of the deduction will vary with the age of the donor-taxpayer, the payout term, and the size of the annual payout in relation to the value of the donated property.

The CRT is a good option if an immediate charitable deduction is desired but there is also a need for an income stream to the donor or another person. The CRT also is a good option where a donor establishes, by a last will and testament, a CRT to provide for heirs with the remainder passing to charities of the donor's choosing.

Highly appreciated securities or real estate often are attractive assets for such donations. The assets may pay scant income to the donor, yet if the donor were to sell the asset, substantial capital gains would be due. If the assets are transferred to a CRT, however, then such assets can be liquidated without an immediate capital gains tax since the CRT is a tax-exempt entity. The entire proceeds can be reinvested to provide increased income to the donor. The donor will pay income tax only as the payments are received from the trust. If the donor wishes to transfer an asset to a CRT ahead of a contemplated sale (such as stock in a closely held company before a buy-out) it is crucial that the donor transfer the assets to the CRT in advance of any agreement to sell the assets to a third party; a signed purchase and sale agreement is fatal.

Two types of CRTs exist: charitable remainder annuity trust (CRAT) and charitable remainder unitrust (CRUT). The primary difference between them is the method of calculating the payment to the donor or donor's beneficiary, as detailed below.

CRAT versus CRUT

A charitable remainder annuity trust is an arrangement in which property is donated to an irrevocable trust in exchange for fixed annuity payments to the donor (or to the donor and his/her spouse, or the donor's beneficiary, such as a child). Annual payments must amount to at least 5% of the fair market value of the donated property at the time of the gift.

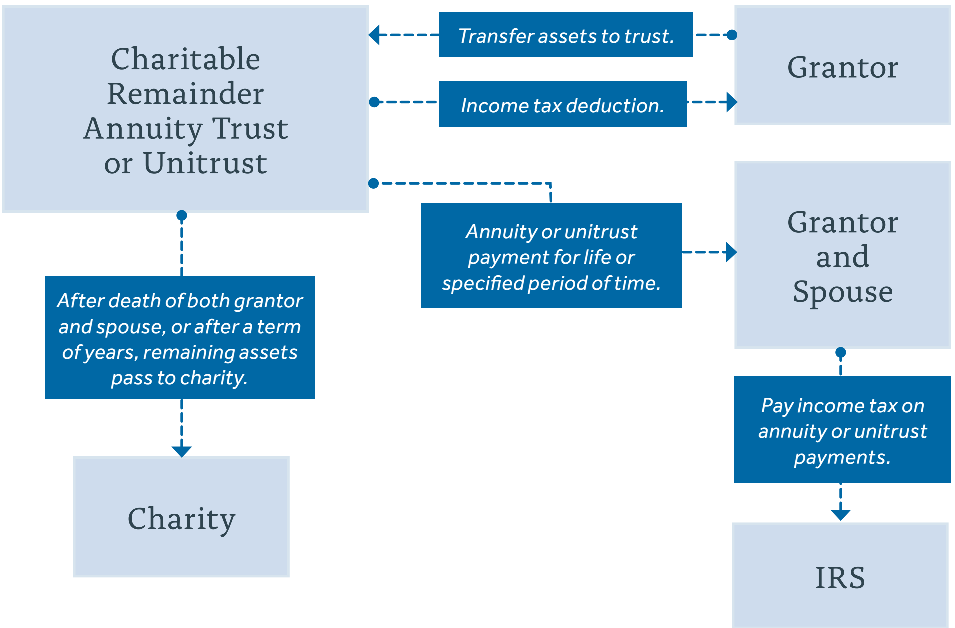
The CRAT can provide income to the donor for life or for a specified term of years not to exceed 20 years. Additional contributions cannot be made after the initial funding.

A charitable remainder unitrust is like a CRAT but differs because the payout to the donor or beneficiary may vary each year. Where the CRAT pays a fixed percentage of the original value of the trust assets, the CRUT pays a percentage of the trust assets as revalued each year. CRUTs also allow additional contributions in subsequent years.

Additionally, there are CRUT variants that permit distribution of the lesser of (1) trust accounting income or (2) the unitrust amount. Trust accounting income is a term of art: it's a creature of state fiduciary statutes and may differ from one state to the next, even though all states have adopted some form of the Uniform Principal and Income Act first established by the Commission on Uniform State Laws in 1997.

Assets best suited for a CRT

The assets best suited to fund a CRT are those assets that have greatly appreciated in value since purchased,



EXAMPLE: Gift to Charitable Remainder Trust

Nick Nylic (age 52) and his wife Nancy (age 50) would like to convert an asset they have been holding for several years into retirement income as Nick is planning to retire soon. For tax purposes, their joint life expectancy is 35 years; in other words, according to statistics, at least one of them should live for another 35 years. Currently, they are in the 37% bracket for federal income tax; no state tax is assumed.

They would like to sell shares of common stock of Nick's employer that he has accumulated over several years through a company sponsored employee stock purchase plan. The stock is currently valued at $2,000,000. The cost basis (what Nick paid for the stock) is $300,000. They would like to liquidate this asset and draw 5% annually from the proceeds during their retirement.

If they sold the stock, they would owe capital gain tax of $340,000[1] and would have net $1,660,000 to reinvest. If they transfer the stock to a CRT instead, they may be able to take an immediate charitable income tax deduction of $358,540,[2] which could reduce their current income taxes by $132,660.[3] The deduction can be used against 30% of their adjusted gross income for the year. If they cannot use all the income tax deduction in the year they transfer the asset to the irrevocable trust, then they can carry it forward for an additional five years.

If the irrevocable trust is drafted to qualify as a CRAT, then following the transfer to the CRAT, the trustee will sell the stock for $2,000,000. Since the trust is exempt from paying capital gains tax, the full $2,000,000 of sales proceeds remains to be reinvested instead of $1,660,000. If the same 5% annual return is used, that will provide Nick and Nancy with $100,000 of annual income which, before taxes, will total an additional $680,000 over their lifetimes. That's $17,000 more in annual income than if they had sold the stock themselves. Furthermore, since the assets are in an irrevocable trust, they are protected from creditors. (If the irrevocable trust were instead drafted to qualify as a CRUT, then $100,000 of income would be the initial annual amount with subsequent annual income being greater or lower, depending upon investment performance.)

1 ($2,000,000 - $300,000) x 20% capital gains tax rate = $340,000; then $2,000,000 - $340,000 = $1,660,000.

2 Based on 5.0% unitrust (annual payout) at 5.0 Section 7520 rate (April 2023).

3 $358,540 x 37% income tax rate = $132,660.

such as publicly traded marketable securities, real estate, and stock in some closely held C corporations. Cash also can be used. Mortgaged real estate usually does not qualify, although you could consider paying off the loan. Stock in an S corporation, unfortunately, will not qualify either since a CRT is not an eligible S corporation shareholder.

Charitable Bailout

Many individuals have large amounts of net worth tied up in the stock of a business conducted as a C corporation. In many of these situations, it is common to have significant undistributed profits in that business entity. For those individuals, a charitable stock bailout program can be designed and implemented whereby the individual causes a portion of the stock to be contributed to a CRT. The CRT will be established to benefit the business owner first for his/her lifetime and then to provide a meaningful legacy to charity. The premise of this technique which makes it so attractive is that it can help the business owner-donor achieve his/her charitable objectives, minimize capital gains tax, and distribute excess cash that has been accumulated in the C corporation tax free. If the owner's succession plan involves transferring ownership of the company to his/her children, the owner also can achieve this goal through this charitable bailout.

The CRT will be established by the client to benefit him/herself and spouse for the greater of their individual lives, or a term of years not to exceed 20 years. In such a situation, the stock will either be sold by the CRT to a third-party outside buyer, a more distant family member or key employees, or redeemed by the C corporation. In the traditional bailout scenario, the senior generation member may be

hoping to emancipate some of the retained earnings which have been accumulating within the company and do so on a tax-advantaged basis while achieving both a philanthropic objective and an estate planning objective. Properly executed, the shareholder can accomplish a succession planning benefit, if that is part of the client's objectives, by causing his shares to be redeemed while those of the younger generation are not redeemed. Rather, those shares are retained by members of the younger generation, and they increase their proportion of corporate control in the process of execution of the transaction.

Notwithstanding the foregoing paragraph, there are a variety of rules and regulations that must be respected to properly carry out the plan and achieve all the desired income tax, estate, and gift tax and succession planning results. In a charitable bailout, an owner gifts stock in the C corporation to a charitable organization, and the C corporation then redeems the stock using the corporation's retained cash. Both the gift of the stock and its redemption are income tax free.

If the charity is public and if the donor has held the stock for more than one year, then the donor is entitled to an income tax deduction for the fair market value of the stock under Internal Revenue Code §170(b)(1). If the gift is made to a charitable organization that is not a public charity, then income tax deduction is limited to the donor's basis in the stock under IRC §170(e)(1). Also, shareholders may elect to donate stock to a CRT for redemption. Normally, if a charity is a private foundation or a CRT, a redemption would violate the self-dealing rules. However, the "Corporate Adjustment" exception of IRC §4941(d)(2)(F) permits redemptions when all stock of the same class as the donated stock is "subject to the same terms" and the charity receives at least fair market value for the stock. To be "subject to the same terms," the C corporation must make a bona fide redemption offer on a uniform basis to the charity and every other stockholder.

The charitable bailout can be very beneficial to all parties involved. It allows a charity to receive cash and a C corporation to bail out its accumulated cash while the donor avoids any built-in capital gains tax on the donated stock. The capital gain on the redeemed stock is considered passive income and, as gain from the sale of property, is exempt from the unrelated business income tax under IRC §512(b).

The charitable bailout technique also can be useful in succession planning. If parents and children all own stock in a C corporation, the parents could reduce or eliminate their ownership stake by contributing their stock to a charitable remainder trust, which stock the company could then redeem. This leaves the children as the remaining (or majority) shareholders, effectively transferring control to the next generation. For this strategy to be effective, the children must be stockholders prior to the redemption and the C corporation must have sufficient cash to effectuate the redemption.[4]

Where the corporation or limited liability company has made a Subchapter S election to be taxed as an S corporation, shareholders may only be U.S. citizen or resident individuals, grantor trusts, estates, and certain tax-exempt organizations (such as an IRC §501(c)(3) nonprofit organization). Shareholders may not be corporations, partnerships, or split-interest trusts, such as charitable remainder trusts. However, a donor advised fund organized as a trust can hold S corporation stock. This means that the S corporation income is taxed at trust rates rather than corporate rates.

Conclusion

A charitable remainder trust can be a very useful planning tool if an immediate charitable deduction is desired, but also if there is a need for an income stream to the donor(s) or another person. The CRT also is a good option to establish by will if the decedent wants to provide for heirs, with the remainder going to one or more favored charities.

4 See IRS Private Letter Rulings 199338046 and 200720021; a redemption by promissory note, and not cash, is a prohibited act of self-dealing.

Robert Ahearn, JD, LL.M., CFP, CLU, ChFC, CRPC, has been with The Nautilus Group since 2016, applying his substantial business, legal, and tax experience to support Nautilus member agents with the development of advanced planning strategies for their clients. As an estate and business planning attorney, Robert worked extensively with high net worth individuals, closely held businesses, farmers and ranchers, private foundations, and public charities. He earned a B.S. in Business Administration from the Boston University School of Management, a J.D. from the Suffolk University Law School, and a LL.M. in Taxation from the Boston University School of Law. Robert is a member of the state bars of Arizona, California, and Massachusetts and the Estate Planning Council of North Texas. He holds FINRA Series 7 and 66 licenses.