www.lawyersusaonline.com
LawyersUSA

Practice makes perfect.
Sub
SIGN
FREE
E-ma

Wednesday, July 12, 2006
Lawy

From the December 05, 2005 Lawyers USA.

Order a REPRINT of this Story

Guest Article

Planned Charitable Giving: A Plain-English Discussion

Part 1

By Jeffrey A. Baskies, Esq.

The level of interest in planned charitable giving appears to have significantly declined in recent years. The increased estate tax exemption (now $1.5 million - $2 million after Jan.1, 2006), the decreased estate tax rate (now 47 percent - 46 percent after Jan.1, 2006) and the reduced capital gains tax rate (now 15 percent) have all diminished clients' eagerness. The potential for estate tax repeal is further limiting clients' interest - and the total elimination of the tax might be devastating to charities. But that's an issue for another day.

ADVERTISEMENT

Get client newsletters tailored to your practice areas!

Click here for more information.

The point of this article (which will be presented in two parts) is to remind planners of the value of planned charitable giving. The first part will provide a "plain English" overview of some of the more popular techniques. The second part will discuss the use of retirement plan assets, annuities or other items of income in respect of a decedent in planned charitable giving.

The definition used here for "planned charitable giving" is any form of a gift to charity that involves an estate planner. Thus, lifetime outright gifts (although they may be in need of income tax planning) will not be addressed. This is not to diminish their value, but simply to limit the article's scope.

Planned Giving With Estate Assets

For the vast majority of taxpayers with assets in excess of $1.5 million (the current applicable credit amount), the most common means of avoiding estate taxes is the use of the unlimited marital deduction. But what happens when the surviving spouse dies? Or what if there is no spouse? Most taxpayers with taxable estates either accept that their heirs will have to pay the

estate tax or purchase insurance to cover it. But for a large number of clients, planned charitable giving can play an important role in estate, gift and income tax planning. Some of the more common methods are described below.

While this discussion is designed to be user-friendly, the specific rules and regulations applicable to any particular situation can be very technical, and it is important to review the relevant statutory provisions before advising clients.

- **Outright Gifts**

The most common and popular form of charitable gift is the outright gift of assets in a decedent's will or revocable trust. Many clients support charitable organizations during their lives and want to include them in their estate plans when they die. Section 2055 of the Internal Revenue Code provides for this estate tax deduction.

Clients often desire to leave a fixed dollar amount, specific assets (e.g., "my Series E Savings Bonds") or a fraction of their estate or trust (e.g., "I leave 25 percent of my residuary estate to ...") to one or more charities. These gifts may be fairly easily incorporated into your client's current estate planning documents - will or trust - or new documents may be created to provide for them. Of course, these provisions are revocable, and the client may increase, decrease or eliminate such gifts at any time.

One point to make with clients who already support a charity is the importance of providing a legacy after they have died and can no longer contribute. For example, a client who donates $500 per year to a charity could include a provision in her will leaving $10,000 to the charity and directing that only the income earned on the devised assets be used. If the assets achieve a five percent return, then the client's $500 annual gift will continue in perpetuity after her death. Obviously gifts may also be substantially bigger.

- **Charitable Remainder Trusts**

Although charitable remainder trusts (and charitable lead trusts) are most often used in inter vivos planning, it is also possible to use such trusts as testamentary tools.

A charitable remainder trust is a vehicle whereby specified individual(s) are entitled to a fixed amount (an annuity trust) or a percentage of the fair market value of trust assets (a unitrust) each year, and at the end of a term of years or upon the death of all the named non-charitable beneficiaries the remaining trust assets pass to one or more charities. The donor who establishes the trust is entitled to a charitable deduction for the value of the trust assets that are anticipated to pass to charity. This calculation is made based upon current interest rates as published by the IRS (the "Applicable Federal Rates" are published monthly), the amount to be paid to the individuals, and either the term of years of the trust or the life expectancy of the individuals.

As an example, assume a 65 year old contributes $100,000 to a charitable remainder annuity trust, retaining the right to receive $7,000 per year for life. If the applicable interest rate were five percent, then based upon the foregoing the taxpayer would be entitled to a charitable deduction of approximately $26,000 in the year the trust is established.

The payments of $7,000 per year are taxed on a four-tier basis. In general, payments are taxed as ordinary income to the extent of ordinary income earned at the trust level, thereafter at capital gains rates to the extent of any capital gains, then as tax-exempt interest (if there is any at the trust level) and finally as a return of principal.

In addition to the charitable deduction that may be allowable at the time of establishing the trust, the primary benefit of a charitable remainder trust is that the trust itself is not taxed, subject to a few minor exceptions. This leads to some outstanding financial and estate planning

opportunities. For example, your client may own low basis ($10,000), high value ($110,000) stock that pays a small dividend. If she sells the stock, a large capital gains tax ($15,000) will be due, leaving less principal ($95,000) to reinvest. On the other hand, the client can establish a charitable remainder trust with the stock and obtain a charitable deduction. If the stock is subsequently sold by the trustee (assuming no prearranged plan), the proceeds (the full $110,000) can be reinvested with no tax paid at the trust level. If the client could achieve a 10 percent return annually, then she would realize $11,000 in income, versus only $9,500 if the trust wasn't created. In addition, the client would also receive a substantial income tax deduction.

An interesting concept used to exist whereby a charitable remainder unitrust was established in order to essentially report the sale of highly appreciated assets on the installment basis. Before the Taxpayer Relief Act of 1997, a client who wanted to sell highly appreciated stock could use this method so as not to report all of the gain in a single year. The client would contribute the stock to a charitable remainder unitrust and elect a very high unitrust amount (20 percent, for example). The stock would then be sold by the unitrust, and 20 percent of the annual fair market value of the trust would be distributed annually to the taxpayer. The ability to reinvest all of the proceeds and defer the reporting of the capital gains more than compensated for the expense of establishing and maintaining the trust. If the client lived long enough, the trust would be virtually exhausted. In addition, all of the capital gain will have been returned (under the four-tier system), but the gain would be spread across a number of years.

Unfortunately, the government has limited the availability of this technique. The law now requires a maximum annual payment of 50 percent *and* an actuarial remainder of at least 10 percent when the trust is funded. Nevertheless, so long as a client is willing to create a trust with a 10 percent remainder, the "installment sale" technique may still be essentially achieved.

It's important to be careful when funding a charitable remainder trust with appreciated assets. Generally, no gain is recognized on the transfer of appreciated property to a CRT; however, pursuant to Revenue Ruling 60-370, when there is a provision in the CRT or when the trustee is under an obligation, whether express or implied, to sell the property and reinvest in tax exempt securities, the gain on the transfer will be taxable to the grantor.

Approximately 14 years after Revenue Ruling 60-370 was issued, the Tax Court considered a case in which the taxpayer donated his stock to a charity. The stock was later redeemed by the corporation. The IRS lost the argument that the gain was taxable to the donor. A few years later the IRS announced in Revenue Ruling 78-197 that it would follow the Tax Court's decision, unless the donee was legally bound or could be compelled to surrender shares for redemption.

Similar results will occur if the owner has negotiated the contract for sale prior to the transfer of such property to the trust. In that case, the IRS will view each step of the transaction as part of one large transaction and thus, will tax the proceeds of the sale to the grantor. If there is no agreement and no "prearranged sale," Revenue Ruling 60-370 should not apply.

Another popular use of a charitable remainder unitrust is where the beneficiary is entitled to an annual distribution equal to the lesser of a specified percentage set forth in the trust instrument, or the actual income earned by the trust. This is coupled with a "make-up" provision which states that if the actual income is less than the specified percentage in some years, the difference will be made-up in future years if the income exceeds the specified percentage.

This technique, which is referred to as a NIM-CRUT (Net Income with Make-Up CRUT), is often recommended for younger professionals, who will invest the trust assets in low yield, high growth securities until retirement age, thereby building up a large "make-up" obligation, and then switch the investments to high yield obligations to be able to distribute not only the annual percentage but also the make-up amount. The idea is to shift income into lower tax bracket years, while reinvesting the corpus tax-free. In essence, this type of trust is a non-qualified, tax-deferred retirement plan, but the creator is not subject to any contribution limitations or other ERISA restrictions. To ensure the client's assets are available to her family in case of an

untimely death, these NIM-CRUT plans are often accompanied by an irrevocable life insurance trust.

A 1998 Technical Assistance Memorandum ("TAM") issued by the IRS seemingly supported the investment of NIM-CRUT assets in tax-deferred annuities. The primary issue was whether the purchase of the deferred annuity policies constituted an act of self-dealing when the named annuitants were disqualified persons. The IRS answered this question in the negative. In addition, the IRS stated that income deferral by a NIM-CRUT is authorized by Sect. 664. Moreover, the IRS determined that Sects. 664 and 4947(a)(2)(A) protect the practice of intentional income deferral from implications of self-dealing when the disqualified person does not control the investment decisions and does not use this control to unreasonably affect the charitable remainder beneficiary's interest.

The other issues presented - whether the annuity policies would jeopardize the trust's qualifications as a CRUT and whether the annuity's withdrawal provision resulted in income to the trust - were also answered in the negative.

Regulations have been published permitting the use of FLIP-CRUTs (NIM-CRUTs which convert to regular CRUTs after a certain event). If the "income" will never be greater than the percentage payout (and thus the "make-up" will never be paid out), then the ability of the trust to "flip" to a standard CRUT may provide some comfort to the grantor. Moreover, the flip can be tied to an event of independent significance. Thus, selling a defined asset in the trust can trigger the flip, or the beneficiary reaching a certain age can cause the flip. Often clients will be advised to put in an identifiable asset (such as a collectible baseball card) into the trust and then use the sale of it as the triggering event.

- **Charitable Lead Trusts**

A charitable lead trust is the opposite of a charitable remainder trust. Under a lead trust, a specified dollar amount (an annuity trust) or a percentage of the annual fair market value of the assets of the trust (a unitrust) is paid to one or more charitable organizations for a period of years. At the end of the specified period, any assets then remaining in trust will pass to named individuals, often children or grandchildren. The value of the gift to the individuals is calculated based upon current interest rates published by the IRS, the annuity or unitrust amount to be paid to charity each year, and the term of years of the trust.

For example, assume a charitable lead annuity trust is established with $100,000, which provides for the charity to receive $10,000 each year for 10 years. Assume the current rate pursuant to IRS tables is 5 percent. Based upon the foregoing, there is a charitable deduction of approximately $77,000. If the trust earns a 10 percent annual return, the full $100,000 would be available to be distributed to the beneficiaries in 10 years and the client only used $23,000 of her applicable credit. In addition, a charity the client supports will receive $100,000.

Several points need to be addressed. First, the amount of the gift to the remaindermen does not qualify for the annual exclusion because it is not a present interest. Second, there is a complex analysis as to whether the present value of the amount passing to charity is deductible for income tax purposes. If the trust is a "grantor" trust, then the charitable contribution is deductible, but the grantor must include all income of the trust in her income each year, without any deduction or setoff for the sums distributed to charity each year (in which case, the trustee may chose to invest in tax-free bonds). If the trust is not a grantor trust, then no charitable deduction is allowed in the year the trust is established. In addition, the trust will be taxable as a separate entity, but it is allowed a full deduction for the amount distributed to charity. Any earnings in excess of the charitable distribution would be subject to tax, but any tax liability would be payable by the trust (not the grantor).

The testamentary charitable lead trust has received much attention since Jacqueline Onassis' death. A charitable lead trust is a perfect vehicle for a family that wants to minimize estate taxes, provide for charity and also provide for heirs. It is all the more useful in instances where the heirs

have the independent financial wherewithal to wait a period of years before receiving the assets.

Assume your client has $2,500,000 in assets, upon which an estate tax of about $450,000 would be due. If your client's will provided that $1,000,000 passed into a charitable lead annuity trust for a term of 15 years, with an annuity to be paid to the charity of $96,000 (9.6 percent), the charitable deduction would be almost exactly $1,000,000 at the IRS table rate of 5 percent. Thus, no estate tax would be due upon your client's death - $1,500,000 passes to her children outright, plus they will get whatever remains in the CLT after the 15 year term. Your client's children could live on their own income plus the $1,500,000 for those 15 years while they wait to receive the remainder. If the trust earns a 9.6 percent annual return, then after 15 years your client's children will receive the full $1,000,000 (over and above the $1,500,000 they already received) - tax-free! Moreover, if the trust receives a higher annual return, there may be even more assets for your client's children. And the client would have provided a great deal of money to the charity. By creating such a trust, your client may fulfill her goals of providing for heirs *and* the charity, all without any estate tax being due. In addition, an irrevocable life insurance trust may be created to provide tax-free even more than $1,500,000 to the children upon the client's death.

Jeffrey A. Baskies, Esq., the former president and CEO of Lawyers Weekly, practices estate planning at Ruden, McClosky, Smith, Schuster and Russell, P.A. in Fort Lauderdale, Fla., where he is board certified emeritus as a specialist in wills, estates and trusts law by the Florida Bar. His column runs regularly in Lawyers Weekly USA,. If you have questions or issues relating to estate planning, please feel free to e-mail Jeff at jeffbaskies@hotmail.com. All questions are encouraged.

© 2005 Lawyers Weekly Inc., All Rights Reserved.

Order a REPRINT of this Story

LawyersUSA Try 6 Weeks Free ■ Newspaper

User Agreement For Subscriber-Only Online Benefits | Help | Our Privacy Policy
Send any questions or comments to comments@lawyersweekly.com

Subscriber Services: 1-800-451-9998 **Technical Support**: 1-800-444-5297 ext. 8156
© Copyright 2006 Lawyers Weekly, Inc. All Rights Reserved

Lawyers Weekly does not use spyware; however, we link to a number of other sites and do not take responsibility for any spyware they ı

This site is best viewed with Internet Explorer 6 (click here to download) or Netscape 7 or higher (click here to download)

208.49.101.98/5.93