An Integrated Look at Charitable Remainder and Charitable Lead Trusts

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“Simple it’s not, I’m afraid you will find, for a mind-maker-upper to make up his mind.” -- Dr. Suess

Most of us can relate to what Dr. Suess had to say. “Mind-making-up” is hard, especially so when it comes to money, taxes, investments and philanthropic goals. It is not simple to know when and when not to use charitable remainder trusts and charitable lead trusts. The income, gift and estate tax rules alone are mind-boggling. Add in time value of money concepts and investment choices, making integrated decisions with these trusts becomes a real challenge.

What are charitable trusts? Why are they used? And, most importantly, when do they make good financial sense? The oft-forgotten investment issues unique to these trusts are discussed. Before we begin, let’s define the oft and over-used marketing buzz-word, “integration.”

Integration

For purposes of this article, integration is the art of uniting assets and investment goals with philanthropic choices and wealth transfer desires. Important non-financial issues such as control over property; impact of inherited wealth on loved ones; and family philanthropic purpose come to mind and weave their way through every choice. Good mind-making-up starts with these important issues and concerns. But in sake of brevity, we limit our integration focus to taxes and investing. With that said, let’s turn first to the charitable remainder trust.

Charitable Remainder Trust

What is a charitable remainder trust? A charitable remainder trust is trust that provides for a specified payment, at least annually, to one or more non-charitable beneficiaries, for life or a term of years not to exceed 20. When the interest of the non-charitable beneficiaries ends, the remainder interest must either be held by the trust for charitable purposes, or paid to or for the use of a charitable organization. Importantly, charitable remainder trusts are generally exempt from income tax. (We will limit our discussion to charitable remainder unitrust (“CRUT”), which pays an annual amount based on the market value of the trust portfolio.)
Why use a CRUT?

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<tr>
<th>What you get…</th>
<th>What you give up…</th>
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<tr>
<td>• Income tax deduction for the present value remainder interest</td>
<td>• Fee ownership of the property</td>
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<td>• Investment compounding on the income tax savings from the deduction</td>
<td>• Investment compounding from the entire property</td>
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<td>• Deferred recognition of capital gains tax (as payments come out of the trust)</td>
<td>• Income tax basis step-up for assets that would have been included in your taxable estate</td>
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<td>• Tax free investment compounding within the trust</td>
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<td>• Stream of cash payments during term of trust</td>
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<td>• Investment compounding on these payments</td>
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The notion that low basis shares can be sold in the trust without paying any current capital gains tax is often the transaction driver. Take the retired Medtronic executive. She may hold most of her (his) wealth in low basis Medtronic shares. She may feel it is prudent to reduce her concentration risk. She may be philanthropically inclined. Should she use the CRUT to reduce her Medtronic exposure? Or would she be better just to sell a comfortable number of the shares and satisfy her philanthropic desires using gifts of low basis Medtronic shares? What economic variables are important? How important is to have a philanthropic intent?

She asks for the “mind-maker-upper” factors, those most important in the sell versus CRUT decision. Number crunching goes on behind the scene. And the models show two important economic variables:

- **Relationship of Basis-to-Market Price** – The income tax basis of MDT must be very low in relation to the market price to justify the CRUT compared to outright sale. Generally speaking, this means basis is less than 10% of the market price. As the basis-to-market relationship increases, so does the case for just selling the stock. This makes sense because as the unrealized gain decreases as a percentage of market value, the tax-exempt status of the remainder trust becomes less relevant.

- **Income Tax Efficiency of the Portfolio Inside and Outside the CRUT** – Envision two diversified investment portfolios: one outside the CRUT (e.g., you sold MDT and must reinvest the after-tax sales proceeds), and one inside the CRUT (e.g. you contributed low basis MDT which was sold inside the trust by the trustee). Now accept this thesis: income taxes are often the single biggest expense of actively managed investment portfolios, at least on the portfolio outside the CRUT. This means that taxes you expect to pay each year on the outside investment portfolio will impact whether or not selling is more attractive than the CRUT. Likewise, the income taxes you must pay on distributions received from the CRUT must be considered, as well. When you mix these two factors, the models show, in general, that recurring short-term capital gains inside CRUT make it a financial loser. Unhelpful short or long-term capital gains from the outside portfolio will reduce the attractiveness of outright sale versus CRUT. The bottom line is this. The “well managed” CRUT portfolio will keep short-term capital gains as low as prudently possible. Being tax-efficient on the outside portfolio boosts the case for just selling. Ignoring the income tax costs of investing in both places is the worst possible outcome.
So how important is true philanthropic intent? More important, I would argue, than any single economic variable. A sincere philanthropic motive can tip the scales towards the CRUT, even where one or several of the economic and tax considerations are less compelling. Where the desire exists to diversify now and philanthropic motive is real, the well-managed CRUT will trump exchange funds and other Wall Street concoctions. Donors that see the trust remainder interest as family social capital that stays in the family will use the CRUT more than families who see the CRUT depriving their family of an inheritance.

Wait one minute! Nothing is said about life insurance, so-called “wealth replacement trusts”. What if she really fears dying early during the trust term, in-effect giving the charity a windfall bequest? This, of course, is music to the ears of some insurance professionals. The use of life insurance to replace trust assets that pass to charity is a valid planning strategy. But too often the charitable remainder trust and the wealth replacement trust are viewed as one. They are not and they never should be. It may make sense to use insurance to replace the property passing to charity, but the face value of the insurable need is not necessarily the fair market value of the property contributed to the trust.

So we can distill down to facts that support the CRUT. Have a true philanthropic spirit, use lowest income tax basis shares, manage the trust portfolio to keep ordinary income inside as low as possible, and if you are along in age or in poor health, use the CRUT reluctantly. It may make more sense to keep the low basis shares in your estate. Finally, if you prefer yield (cash flow) inside the CRUT, don’t discount the importance of dividends. Not only are they an important component of equity returns, they will generally be taxed at 15% when they come out of the trust.

**Charitable Lead Trust**

What is a charitable lead trust? A charitable lead trust is a split-interest trust that has two property interests: a lead interest, which makes payments to one or more charitable organizations, and a remainder interest, which passes outright or in trust to designated persons when the lead charitable interest ends. When a charitable lead trust is funded during life, the grantor (the person establishing the trust) makes two gifts: a charitable gift (of the lead interest) and a taxable gift (or the remainder interest). Assume we are talking here about so-called “non-grantor” lead trusts, which are treated as a separate taxpayer for income tax purposes. Assume further that we are addressing a charitable lead annuity trust (“CLAT”), a trust that pays to charity a fixed amount every year based upon the initial market value of the portfolio.

**Why use a CLAT?**

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<td>Assets removed from your estate</td>
<td>Fee ownership of the property</td>
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<td>Growth on trust property above a certain prescribed IRS rate (“hurdle rate”) passes estate tax free to next generation</td>
<td>Future after tax compounding on the property</td>
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<td>Annual income tax deduction at the trust level for annual payments to charity</td>
<td>Right to revoke the trust</td>
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<tr>
<td>Right to subtract the discounted present value of expected charitable payments in calculating the gift (or property subject to estate tax) on trust funding</td>
<td>Income tax basis step-up for assets included in your taxable estate</td>
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Mind-making-up seems harder with the CLAT than the CRUT. Why would one give money to charity when you don’t get a current income tax deduction for doing so? And what is this IRS rate all about? Or this mumbo jumbo about subtracting some “discounted present value?” Let’s address these points.

Archimedes, the Syracuse scientist and mathematician, is quoted as saying, “Give me a fulcrum, and I shall move the world!” While his use of the fulcru m and leverage arose primarily in war against the Roman Empire, the notion of leverage arises in the CLAT, as well. Consider simplistically a $10,000,000 15-year CLAT. The annual payout you direct to charity from the $10,000,000 contribution is valued by discounting this payment stream back to present day terms using a prescribed IRS rate. (As of this writing, the rate is 5.00%) It might be, for example, that the payment stream you direct (the lead interest) is valued at $9,750,000. This means the gift (the remainder interest) is $250,000. Importantly, how the IRS values the remainder interest has zero to do with the actual investment return that comes to pass within the trust. And if the compound after-tax investment return in the CLAT exceeds the IRS discount rate, the excess after-tax return benefits the trust remainder persons, free of additional gift or estate taxation. Therein lays the leverage, the fulcrum, so to speak.

The government provides a rate to figure the value of a retained annuity stream. This amount isn’t a gift because the trustee has to give this amount away to charitable organizations over the term of the trust. But if my trust compounds at a rate that exceeds the IRS discount rate, whatever is left in my trust goes to the kids free of further gift or estate tax.” Precisely right!

That said, when does the CLAT, in general, make good economic sense? No mumbo jumbo about other tools, like the grantor retained annuity trust, sales to defective trusts or even the math of outright gifts. You model again and come back with four important economic variables:

- **Relationship of Basis to Market Price** - Charitable lead annuity trusts created during life are best funded with high basis assets. Putting low basis shares into the CLAT raises a host of issues. One is that the IRS hurdle rate is an after-tax rate. Imagine the low basis Medtronic going in and the trustee saying, “Prudence says you diversify the portfolio. Don’t let that tax tail wag the portfolio dog. Sell some MDT now.” Prudence may be the right fiduciary answer but precisely the wrong investment answer, especially where the trust (not the grantor) is paying the capital gains tax. Selling means 15% to 20% of the value in the CLAT goes to the IRS, which means the remaining 80% to 85% must work harder to be at the IRS rate over the term of the trust. What makes sense will vary case to case, investor to investor. Clients with philanthropic desires who are aged or in poor health will usually find waiting until death to fund the CLAT the optimal solution, even though you lose the certainty of knowing what the interest rate will be when you fund the trust.

- **Interest Rate on Funding** – Charitable annuity lead trusts are most efficient from a transfer tax perspective when they are funded at a time when interest rates are low. This is because the lower the discount rate, the greater the discounted present value of the charitable interest; therefore, the lower the present value of the trust remainder interest that is subject to gift (or estate) tax. The flipside of this, of course, is that precisely when interest rates are low asset prices, in general, discount this fact and may be priced high and offer less-than-attractive upside appreciation over the term of the trust.

- **Portfolio Volatility** – The IRS discount rate assumes investments compound at a steady rate, like walking up the basement steps. We know from recent past experience that this never happens. Downward asset price volatility, especially in the early years of a charitable lead trust, can cause the trust assets to perform at a long-term rate that is less than the prescribed IRS discount rate. For example, consider Mr. and Mrs. Plenty Bucks, good folks who finished reading Jeremy Siegel’s “Stocks for the Long Term,” in December of 1999. After experiencing 20% returns from the portfolio for years, in March of 2000 they decide to put $10,000,000
cash into a 15 year CLAT: invested 50% SP 500 Index and 50% Russell 2000. The IRS rate at
this time was 8.2%. Fast forward two years to March of 2003. The SP 500 investment is worth
$3,175,000. The Russell 2000 investment is worth $3,150,000. The trust is paying out based
on a $10,000,000 initial market value. Even with 2003’s rising tide lifting both large and small-
mid cap shares, odds say this CLAT is underwater to stay! Not only must it recoup its’ loss, it
must also compound at a rate higher than 8.2% over the remaining trust term. The Bucks take
some consolation that they didn’t pay much gift tax to fund their CLAT. Things could have
been worse. But their CLAT offers little odds of generating a return that exceeds the IRS hurdle
rate over the remaining 12 years of the trust.

- **Income Tax Efficiency of the Portfolio Inside the Trust** – All we can note here is that
investment portfolios must be mindful of two important income tax rules. First, non-grantor
charitable lead trusts are entitled to a tax return deduction from gross income for amounts paid
or permanently set-aside for a charitable purpose. Second, the rules governing what income (in
the trust) comes out first and is applied against the deduction provide opportunity for the
attorney to enhance the income tax income efficiency of the trust. Investments such as hedge
funds, normally very tax-inefficient, may be perfectly suited for ownership within the CLAT.
In fact, the Bucks wish they had held an adequate weighting in hedge funds instead of equities,
at least at the outset of their CLAT, to guard against getting way behind the eight-ball early.

“Mind-making-up” with the CLAT is going to require further ciphering and figuring out. It might in
fact be easier just to give some more money to the children and grandchildren. But enough in-favor facts
surface, such as a sincere philanthropic intent; no need for or ability to claim an income tax deduction
for charitable contributions and unwillingness or reluctance to pay gift taxes to pass additional wealth
on to children. Finally, consider generation skipping tax considerations whenever remainder interest
does or could pass to grandchildren.

**Conclusion**

Persons with financial abundance and a philanthropic spirit are blessed to have many ways to benefit
society with their financial gifts and resources. Charitable remainder trusts and charitable lead trusts are
just two planning tools in a quiver of multiple arrows. And deciding when they fit isn’t easy. When,
where and why they fit will depend on a number of tax, economic and all-important non-financial goals
and concerns. It is the burden on the advisor to lift the yoke of complexity, to bring philanthropy alive in
a practical, rewarding manner. Investment advisors who manage CRUT and CLAT portfolios need to be
familiar with the income tax rules surrounding these tools. Despite good intentions, integrated portfolio
management in these trusts and other asset locations is often over-sold and without real substance. Ask
the right questions before using these trusts and before entrusting your hard-earned capital to an
investment advisor.

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1 IRC Section 664 (d) (1) & (2)
2 IRC Section 170 (c) (2) (B), IRC Section 2055 (a) and Section 2522 (a)
3 A trust that pays the non-charitable beneficiary an annual amount equal to a fixed percentage of the trust assets,
revalued each year. The payment does change with portfolio appreciation or depreciation.
4 While not discussed in this article, donors who are elderly should consider the impact of the basis step – up on their
decision to use the CRUT instead of simply keeping the stock in their estate, especially if philanthropic motivations are
a secondary concern in the transaction.

The rules and regulations under IRC Section 664 establish an inception-to-date priority pool system, taxing annual trust distributions as follows:

- First, as ordinary income, to the extent of the trust’s ordinary income for the current year and its undistributed ordinary income for prior years. Ordinary income includes items such as taxable interest, dividends and rents.
- Second, as capital gain to the extent of the trust’s undistributed capital gains for the current year and undistributed capital gains for prior years.
- Third, as other income (e.g., tax exempt interest) to the extent of the trust’s other income and undistributed other income for prior years.
- Finally, as a tax-free distribution of trust principal.

This is because the distributions coming out of the trust are first taxed to the grantor-trust beneficiary as ordinary income under IRC Section 664 (b) (1) to the extent the extent of trust accounting income. Qualified dividends, however, retain eligibility for the 15% federal rate.

Short or long-term gains realized that generate an income tax cost but add no long-term value to the portfolio. These are securities trades, which in investment lingo, have no “after-tax” alpha.

If we isolate the potential insurance need on CRUT assets, the face value needed to replace the trust assets is ((1-.55)* trust assets)), as this is the amount the beneficiaries would have after-tax if such assets passed through a taxable estate. And, if you think about it, replacement insurance need declines over time as cash comes back out of the trust, to be reinvested and compounded outside the trust. Thus, other things being equal, the product-of-choice might be decreasing term.

Distributions from the CRT are generally taxed based upon a “worst income tax rate, first out (WIFO)” system. Strict application of the “WIFO” rules would result in short-term capital gains deemed distributed before dividends. This isn’t the case, however. Qualifying dividends pass out before short term capital gains. Thus, other things being equal, an equity income portfolio that is managed to generate a healthy and growing stream of dividends may be a better than portfolios where return comes more from share price appreciation.

The relevant Code sections here are Sections 641 and 671. Suffice to say, in some situations the grantor is treated as the taxpayer of the trust and in others tax is paid at the trust level. Which is better is beyond the scope of this article.

The retained interest under a charitable lead trust is their present value determined under general actuarial principles. Three elements must be considered: the term of the trust (t), the interest rate (i), and the annuity payment (p). The interest rate assumption is set forth in IRC Section 7520 and the regulations there under. Leverage arises when the actual rate of investment return on trust assets exceeds 7520 rate, which benefits the trust remainder beneficiaries without further imposition of additional transfer tax.

IRC Section 642 (c) provides a deduction from gross income amounts actually paid to or set aside for charitable organizations. Gross income means fiduciary accounting income, and this is defined under state law and, to some extent, may be modified by the terms of the trust.

Non-grantor trusts cannot claim the 642 (c) offset to the extent it is allocable to unrelated business taxable income (“UBTI”). In most instances, hedge fund ownership will take away some of the deduction, but not to a degree which negates the desirability of using the lead trust as a holding structure.

IRC Section 170 and related regulations impose percentage limitations on a taxpayer’s ability to deduct charitable contributions. Generous individuals who consistently exceed their percentage limitations may benefit by funding a non-grantor charitable lead trust. Income and capital appreciation from assets in the lead trust would be taxed to the trust and taxation may be lower than it such assets were held by the donor and taxed at the top marginal income tax rates.

The GST implications in charitable lead trusts are important but beyond the scope of this article.