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Fundraising (and Maybe Acquisition Planning) with Charitable Remainder Trusts

by William T. Hutton

Picture this: You answer the door to find a man in a long black coat, grey fedora pulled low over his eyes, glancing furtively from side to side. He rasps, "Listen up quick. You got any property you don't wanna sell on accounta the income tax hit, I got the answer. My cut's only a fraction of the taxes you save, but you gotta move fast. This is a limited-time offer."

Your reaction? Right, you'd probably call the vice squad. But the man is legit. His name is Charity, and he does indeed have a deal for you.

The extraordinary opportunities for tax savings upon the disposition of appreciated property through the medium of a charitable remainder trust have recently burst upon the public consciousness (or, at least the consciousness of charitable solicitors and financial planners). Those possibilities have been lurking for over two decades in Section 664 of the Internal Revenue Code, but have only recently been discovered by the insurance industry, now hell-bent to exploit them. Being center-stage at the insurance follies virtually assures that the attractions about to be described will not be long-lived.

First, some words of warning. In order fully to understand the hypothetical games about to be played, it will be necessary for us to describe, in some detail, the origins and nature of the charitable remainder trust. This part is fascinating to the connoisseur of tax statutes gone berserk, but may not rivet the general audience. Second, it is absolutely essential to apprehend that a dollar today is worth more than a dollar tomorrow, and that a dollar today is worth a lot, lot more than a dollar thirty or forty years from now. Finally, we must acknowledge at the outset that the land trust's principal use of charitable remainder trust strategies will be to provide for future operating income and endowment, and that they may serve to facilitate land acquisitions only in quite unique circumstances.

The Historical Premises Underlying Section 664

Prior to the Tax Reform Act of 1969, charitable remainder trusts were not specially treated in the Code. Although it was perfectly feasible to create a trust to pay income to one or more persons for a term of years or for life, with the principal (or "corpus") passing to charity at the termination of the income term, such creatures were dealt with under the general rules of trust taxation, which then allowed a charitable deduction for any amount of the trust income, without limitation, which was paid to, or "set aside" for the benefit of, the charitable remainder beneficiary. Thus, if such a trust sold assets productive of capital gain, and that gain were allocated to the principal of the trust (rather than paid out to the income beneficiaries), the trust obtained a charitable deduction for the full amount of the capital gain since it had been "set aside" for the ultimate charitable remainder beneficiary.

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In the eyes of the Treasury Department, pre-1969 charitable remainder trusts were the source of irresistible temptations to their creators and income beneficiaries. Consider:

Zane Sturdley creates a charitable remainder trust, funding it with highly appreciated Sturdley Amalgamated Common Stock (basis $50,000, value $1 million). Trustee sells the Sturdley stock, setting aside the capital gain (tax-free) for the benefit of the ultimate charitable remainder beneficiary, the Quonset Hut School of Chiroprody, and invests the proceeds of sale in commercial mortgages producing (then astronomical) eleven percent rate of return.

At the creation of the trust, Zane was entitled to a charitable deduction based upon the present value of the School’s remainder interest. Under then applicable Treasury tables, the value of that remainder interest was computed upon the assumption of a 3-1/2% income yield. The risky investment strategy adopted by the trustee, however, dramatically favored Zane Sturdley, the income beneficiary, to the considerable detriment of charity. There was, in short, a dreadful lack of correspondence between the assumptions upon which the charitable deduction was computed and the facts of life.

The (Apparently) Elegant Statutory Cure

The cure, as provided in the 1969 Act, was to give charitable remainder trusts their own separate niche in the Code. Section 664 in effect provides a scheme of taxation for charitable remainder trusts which is entirely separate and apart from the treatment of trusts generally. That scheme—

(1) Prescribes an inverse relationship between the amount of the annual payout to income beneficiaries (expressed as a fixed-dollar annuity amount or as a percentage of the value of the trust assets) and the charitable deduction allowed upon creation of the trust. A trust which pays a fixed-dollar annuity is called a "charitable remainder annuity trust," and the annuity amount must be set at not less than five percent of the initial value of the trust assets. If a percentage payout is chosen, the trust is called a "charitable remainder unitrust", and the annual payout to the income beneficiaries must not be less than five percent of the value of the trust assets, valued annually. (Since the unitrust offers the more exciting and flexible opportunities, the balance of our discussion will be directed to uses of that vehicle.)

(2) Provides an income-characterization system under which the income beneficiaries' treatment is governed by the historical earnings of the trust, rather than pursuant to a year-by-year measure. Under that system, all of the trust's ordinary income (dividends, interest, etc.) must be distributed before the capital gain "tier" is reached, and, similarly, all of the capital gain income must be deemed exhausted before the beneficiaries may receive tax-exempt interest income. Last in the line of tiers, after all others are entirely depleted, is the
trust principal.

(3) Confers tax-exempt status on the charitable remainder trust, except for any year in which it realizes any unrelated business taxable income. Since unrelated business income activity is generally foreseeable and avoidable, attainment and maintenance of tax-exempt status is no great trick.

In concept, the creation of Section 664 was an apparently elegant solution to the perceived dilemma that charity reflected in Zane Sturdley's investment policies. The amount of the charitable income or estate tax deduction obtainable upon the creation of the trust is determined with reference both to actuarial expectancy (as before) and the prescribed payout. The higher the income payout, the smaller the charitable income or estate tax deduction.

But there is a little more to the legislative story. At the same time that Congress created the private preserve of Section 664 for the charitable remainder trust, it also determined to eliminate the historical charitable deduction for trusts at large, except for amounts actually paid to charity. Thus, no longer would it be possible for a typical family trust to attain a charitable deduction for amounts simply "set aside" for an ultimate charitable beneficiary.

Against the backdrop of the change depriving trusts generally of the "set aside" deduction, a decision had to be made regarding the treatment of the newly created charitable remainder trust under Section 664. If such a trust should realize a large capital gain (allocated to principal under traditional trust accounting principles), or should it realize income in excess of that required to be paid out in a particular year, how should those amounts be treated? Since the ultimate beneficiaries were, by statutory prescription, charitable entities, Congress simply provided that charitable remainder trusts were to be treated as tax-exempt entities (except for any year in which unrelated business taxable income might be realized, as noted above.) Thus the old "allocated to principal" thinking, which pays not the slightest heed to time-value concepts, survives (as an endangered species, perhaps) in Section 664.

Observe, however, that attainment of charitable remainder trust status demands no minimum charitable remainder value. Either a trust which names the last surviving Civil War widow or her two-year-old granddaughter as income beneficiary will qualify. Thus, the separate statutory treatment of charitable remainder trusts in Section 664, conceived as a slick, mathematical solution to a (probably minor) tax-avoidance problem, has bloomed at the age of 22 into one of the last great "too-good-to-be-true" opportunities of the 90's. To illustrate:

Salamanca Replevin, 42, has achieved success in the world of options and securities trading beyond her wildest imaginings. From her sizeable portfolio she is about to pluck several long-held investments (aggregate cost basis $200,000, value $1.2 million), each of which is ripe for sale. Suppose, instead of an outright sale, she contributes those securities to a charitable remainder unitrust, which provides for a 7% payout for the joint lives of Salamanca and her spouse, Rocquefort, 40. As Trustee, she then sells those securities, tax-free, and reinvests the proceeds in a portfolio providing both a 7% + return and some growth potential. Applicable joint-and-survivor annuity tables indicate that the value of their life estate in the unitrust is approximately 85% of the present value of the trust; i.e., the donation of the charitable remainder produces a $180,000 current income tax deduction--15% of $1.2 million.

The attractions of this scenario are manifest, and have precious little to do with the warm glow of benefaction. At an assumed applicable federal/state combined income tax rate of 35%, Salamanca has avoided $350,000 in current income taxes, at an economic cost of perhaps $120,000--the present value of the charitable remainder interest donated, less the current income tax benefits attributable to that gift. Further, if Salamanca, serving as trustee, can achieve a total return exceeding the required 7% payout, the tax-free accretions to the trust corpus will amplify her trust income in the years to come. If she is able, for example, to realize an average annual total return of 11%, the trust will double in value every 18 years, and as Salamanca and Rocquefort near the end of their actuarial life expectancies, they will draw an annual retirement income of $336,000--four times the initial annual distribution.

All of these wonders have been entirely attainable for the past 22 years, but the appreciation for Section 664 was quiet and respectful until the insurance industry discovered how to "package" it. The insurance pitch goes like this: If Salamanca and Rocquefort should feel pangs of remorse about committing such an (eventually) sizeable chunk of their wealth to charity, they ought to contemplate socking the immediate income tax savings, give or take a bit, into whole life insurance policies held as the sole or principal assets of an insurance trust for the benefit of their offspring. Properly conceived, the assets of the insurance trust will not be subject either to income or estate taxes, and their children will have much less cause to produce recollections of childhood abuse for the tabloid trade.

In the view of this commentator, the insurance feature of the unitrust plan may be a useful appendage, but it is hardly an essential ingredient of a sound plan. In certain circumstances the tax advantages of planning with life insurance trusts may outweigh the (typically inferior) investment return on a whole life policy; in
other cases—as where the donor is elderly and the cost of whole life insurance is prohibitive—it may not be affordable.

On a present-value analysis, the opportunity presented to Salamanca and Rocquefort by the charitable remainder trust statute represents wretched tax policy. The Treasury has foregone hundreds of thousands of dollars in tax revenues ($350,000 initially, plus the value of tax exemption for any surplus income over the next forty years or so), all to inspire a gift to charity equal to about $180,000, at present value. Should there be any lingering doubt about that judgment, let’s push this vehicle right up to the brink. Suppose, for example, that Salamanca and Rocquefort, worried that their lifetime gift-and-estate tax exemptions of $600,000 each may suffer Congressional pruning, decide to use those exemptions now. Accordingly, they establish a charitable remainder unitrust for their four children, ages 2 through 11, funded with the same $1.2 million of highly appreciated securities. Further assuming a mere 5% income payout, the present value of the charitable remainder is about four-tenths of one percent, producing a present charitable deduction of less than $5,000 (which, of course, is not the strategic point).

If Salamanca can achieve an 11% total return for the children’s unitrust, it will double in value every 12 years, thanks to the wonders of tax-free compound growth. By the time the first child has completed a baccalaureate, the fund will have grown to $2.4 million. When the youngest turns 30, it will be over $5 million. And when the curtain is drawn on the last act of the last Replevin child, the release from trust of the corpus of about $150 million ought to provide the excuse for a considerable celebration in the development offices of the Sasquatch Land Trust, or whomever.

This last example is intended to illustrate the inanities of tax policy in the Section 664 area, but it is certainly not a farfetched investment proposition. To the land trust development officer, however, whose tolerance for delayed gratification is about equal to the interval between lunch and dinner, it is apt to seem absurd indeed. So be comforted by the realization that most charitable remainder trust planning is done by persons of middle age or above, and that the present value of the charitable remainder created will often approach, or even exceed, the tax savings achieved upon diversification. Thus, the land trust should view charitable remainder trust planning as an exceedingly useful way to induce the gift of an ultimately significant amount of operating support or endowment assets.

A Few Cautions

Before turning to the possibility of employing the charitable remainder trust in a land acquisition plan, let us first discuss a few technical and not-so-technical traps for the uninitiated:

1. Funding the trust with appreciated property on the eve of a planned sale of that property invites an “assignment-of-income” attack. That label is tax jargon for an IRS attempt to tax the gain on a sale to the person who is responsible for it. Formalities such as title passage or documentation are not determinative; if the circumstances indicate that the donor negotiated the disposition prior to contribution of the property to a charitable remainder trust, the tax liability will fall upon the donor, and the intended tax-free diversification will have been frustrated. Ideally, no negotiations for the disposition of the property will have occurred prior to its contribution to the trust. If so, the trustee should take all possible steps to negate any inference that a deal has been struck outside the trust. From the writer’s own observations, the creation of unitrusts with pre-sold properties ought to be an area in which the IRS prowls like a cat in an aviary.

2. Encumbered property is rarely a fit subject for contribution to a charitable remainder trust. Since the production of even one dollar of unrelated business taxable income will destroy the trust’s tax-exempt status, and since debt-financed properties are a source of unrelated business income, the threat to a tax-free diversification plan is obvious. (In certain circumstances, property subject to indebtedness acquired by bequest, or by gift provided that the mortgage was placed on the property more than five years before the date of the gift, may be sold without producing unrelated business income, but the statutory escape hatches should be very carefully examined prior to the implementation of either such contribution plan.)

3. If undeveloped land or low-yield stock is intended to fund a charitable remainder unitrust, there may be an understandable reluctance to commit to an immediate payout before the trustee arranges for sale of the contributed assets and diversification into properties producing a substantial income stream. Fortunately, the statute provides an exceedingly useful election, whereby the unitrust agreement may limit the payout to the actual trust income (i.e., interest, dividends, royalties, etc., but not including capital gains), where such income is lower than the amount determined by the payout percentage. Pursuant to that election, a unitrust funded with raw land would have no obligation to make payments to the income beneficiaries until the land was sold and the proceeds reinvested. The statute also permits a so-called “make-up” election, whereby the deficiencies in income during the period of reduced payments (in our example, before the land is sold) are permitted to be made up out of income surpluses in later years.
(4) Charitable remainder trusts are treated as private foundations for several purposes, and it therefore behooves the advisor to consider the potential impact of the private foundation rules on anticipated future transactions. Private foundations are subject, among many other excise-tax-backed sanctions, to categorical proscriptions against self-dealing transactions. It would hardly do, for example, to fund the trust with stock of a closely-held company, for which the only logical market is the company itself, by way of a stock redemption. If the company should be a "disqualified person," the redemption route will be barred by the self-dealing rules, and the trust may be left with undiversified, unmarketable, and low-yield property.

Providing Immediate Land Trust Support

Once the prospective donor has been educated to the financial benefits of charitable remainder trust giving, enthusiasm for this device may be almost boundless. At best, it's an absolute moneymaker, at worst (as with an elderly income beneficiary), it may be perceived as a decision to support the land trust rather than pay the IRS. But the land trust's excitement is apt to be more tempered, for it must wait, after all, for twenty or thirty or fifty years for the remainder ship to come in. Can't it enjoy a present taste of the 21st-century largess?

Not through the medium of the trust, unless the donor agrees to make it an income beneficiary (permissible provided that there is at least one noncharitable income beneficiary). The trustee bears a fiduciary duty which requires the maximization of return to the trust, for the benefit of both income and remainder beneficiaries. Thus it is accepted wisdom that the trustee is unable to sell trust property at a bargain price, even if the bargain runs to the charitable entity also irrevocably named as the remainder beneficiary. Any bargain will have to be conveyed outside the trust.

But a gift outside the trust is not, perhaps, such a remote prospect. Suppose, for example, that the land trust is instrumental in bringing the remainder trust opportunity to the attention of Thalweg Jones, who seeks to diversify a $2 million portfolio of low-yield growth stocks into high-yield investments, tax-free. The land trust's development officer, pouncing like a mongoose at the moment of greatest vulnerability, gently suggests to Thalweg that a direct donation to the land trust equal to five percent of the portfolio would be an appropriate gesture (we would also hope, of course, that the land trust be named as remainder beneficiary). If not five percent, how about three percent? You get the idea.

Highest Ambitions--the Land Acquisition Scenario

Achieving a direct gift of investment property outside the trust is child's play compared to the difficulties of building a charitable remainder trust plan into a land acquisition scenario. Obviously, if the land trust is prepared to pay full market value, the target property can be contributed to the trust and sold by the trustee, subject to the caution about "assignment-of-income" doctrine expressed above. But if the land trust expects to make the acquisition at a bargain price, it would appear to be necessary to divide the property, with the bargain slice passing outside the trust, and the rest going to fund the unitrust, with a subsequent sale by the trustee.

Suppose, for example, that the Moose Hollow Land Trust is prepared to pay $375,000 for Greta Bump's 800-acre farm, appraised at $500,000. Before the deal is made, Greta concludes that a $375,000 charitable remainder unitrust providing a nine percent payout will amply furnish the autumn of her life, and so she contributes an undivided 75% interest in the farm to a newly created unitrust with an income-only feature. As trustee, then, Greta subsequently negotiates a sale of the trust property to Moose Hollow for $375,000, and, at the closing, gratuitously conveys her retained 25% interest directly.

That transaction ought to work. It places a heavy premium on awareness of the assignment-of-income threat, and assumes that Greta can be convinced of the wisdom of charitable remainder trust planning, whether or not a sale out of the trust is arranged with Moose Hollow. (If that deal falls through, she may of course simply contribute the additional 25% interest to the trust, and sell the entire, reunited property out of the trust for its full fair market value.) The self-control required of the land trust, which will have to convince Greta, initially, as to the soundness of the basic structure without seriously broaching sales negotiations, is considerable. But if the reality of the trustee's sale may be proved by demonstrating his right not to have made it (as is believed in this corner), a little self-restraint may produce a very large payoff.