# Minimizing Gift and Estate Taxes Through Charitable Trusts

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American Institute for Cancer Research®

## Major Gifts, Trusts and Bequests to the American Institute for Cancer Research

The American Institute for Cancer Research is devoted to the task of conquering our nation's most dreaded illness. Each year, the Institute sponsors important research projects at universities and research facilities across America on the cause and prevention of cancer. And it has long been a leader in providing effective educational programs on the prevention of cancer – directed to both health care professionals and the general public.

The primary focus of the American Institute for Cancer Research – in both its research projects and its educational programs – has been the role of diet and nutrition in the development and prevention of cancer. (There is scientific evidence that diet and lifestyle changes could reduce incidence of cancer by 30 to 40%.)

We are winning the war against cancer. But there is still a great need for additional scientific research on the cause, prevention and treatment of cancer. And as we learn more about the role of nutrition in the cause and prevention of cancer, our educational programs become more and more important and rewarding.

Millions of Americans provide financial support to our programs – often through tax-planned gifts, trusts and bequests. To encourage, facilitate and recognize this very important financial support, the Institute has created the League of Willful Cancer Fighters. We will be pleased to enroll in the League any client who has made or intends to make a bequest to the Institute or to name the Institute as the beneficiary of a trust, a life insurance policy, a retirement death benefit or other form of estate gift. We invite you or your client to call us at your convenience.

To encourage generous gifts to the Institute and other charities, we have prepared this booklet to help attorneys and other financial advisors understand all the important tax and financial rewards Congress has provided. Our staff can provide the exact tax and financial consequences of any gift, trust or bequest your clients may want to consider. And because we are so active in this specialized field, we can provide whatever technical and practical information you may request for planning and drafting a charitable gift arrangement that will provide your clients both the greatest personal satisfaction and the greatest tax and financial rewards.

Please feel free to call the Gift Planning Department at any time. Our toll-free telephone number is 1-800-843-8114. And please . . . if the opportunity presents itself, inform your clients about how a gift, trust or bequest to the American Institute for Cancer Research can further the fight against cancer and also enhance their personal tax, investment, retirement and estate plans.

# MINIMIZING GIFT AND ESTATE TAXES THROUGH CHARITABLE TRUSTS

Charitable remainder trusts and charitable lead trusts can sometimes play a vital role in the estate planning of a client.

An inter vivos or testamentary charitable remainder trust can be drafted to provide a high, dependable and often tax favored income for family members or other beneficiaries of the client. And because the trust can significantly reduce estate taxes at the death of the client, more of his or her estate will be available for family members. In many cases, depending on the specific assets held by the client, a charitable remainder trust can also produce important income tax benefits for the family members and other beneficiaries of the client.

Equally important, your client may find great personal satisfaction in knowing that the property transferred to the trust will eventually pass to the American Institute for Cancer Research and be used to bring us closer to the day when cancer is no longer such a terrible threat to our society.

A carefully planned charitable lead trust can also be a great way to enhance the estate plans of some clients. It can permit your client to make a major contribution to the war against cancer, pass special assets to family members and minimize estate and gift taxes.

Despite the proven ability of charitable trusts to significantly minimize estate, gift and generation skipping transfer taxes, it seems clear that most charitable trusts are created primarily for philanthropic, investment, retirement and income tax planning purposes. But without regard to the client's primary motivation, all charitable remainder trusts and lead trusts have some transfer tax consequences.

The basic gift tax, estate tax and generation skipping transfer tax consequences of most remainder trusts and lead trusts will be discussed first in this booklet. Practical suggestions for the actual planning and drafting of a charitable trust as part of a plan to minimize gift and estate taxes will be discussed later in this booklet.

# BASIC TRANSFER TAX CONSEQUENCES OF CHARITABLE REMAINDER TRUSTS

## Nature of the Federal Gift Tax

The federal gift tax law provides, in effect, that every gift in excess of the annual exclusion amount (and every gift of a future interest) to an individual beneficiary made during a calendar year must be reported on a federal gift tax return. The gift tax law does allow:

(a) a charitable deduction for gifts to organizations qualified under section 2522 of the Internal Revenue Code (the American Institute for Cancer Research is fully qualified for all gift tax, income tax and estate tax charitable deductions);

(b) a marital deduction for most gifts made to the spouse of the donor;

(c) an annual exclusion of up to and including $13,000 (indexed for inflation) for present interest gifts made to each of any number of individuals during the calendar year; and

(d) double exclusions if the spouse of the donor agrees to "split" the gift for gift tax purposes.

Gifts in excess of the charitable deduction, marital deduction and annual exclusions are taxable gifts. They do not create any immediate tax liability until total taxable gifts exceed the amount sheltered by the gift tax credit. But at the death of the donor, all taxable gifts made during life are added to the value of his or her estate in determining federal estate tax liability.

## Federal Gift Tax Consequences of an Inter Vivos Charitable Remainder Trust

There will always be some form of gift when a client creates a charitable remainder trust during his or her life. For federal gift tax purposes, the trust itself is ignored and the gift is considered to have been made to the beneficiaries designated in the trust agreement. Typically, the trust agreement will name one or more individuals to receive an annuity or unitrust amount for life (or for a period of years) and direct that the principal of the trust be paid to the American Institute for Cancer Research or other qualified organizations at the death of the income beneficiaries (or the end of the term of years period). Note that a gift tax return (Form 709) is required for every charitable remainder trust, even where the donor is the only income beneficiary.

The present value of the remainder interest given to the American Institute for Cancer Research (or other qualified charity) will qualify for a gift tax charitable deduction. The present value of an annuity or unitrust interest given to the spouse of the donor will generally qualify for a marital deduction provided there are no individual beneficiaries other than the donor and his or her spouse. The value of the interest given to every other individual beneficiary will qualify for an annual exclusion provided payments to that individual are to start immediately.

For example, assume that a client, age 72, transfers $200,000 to a charitable remainder unitrust that will pay 5% of the value of the trust to him and his wife, in equal portions for their joint lives and then to the survivor. After the death of the survivor spouse, the unitrust amount will continue to be paid to their daughter for as long as she may live. At the death of the survivor beneficiary, the principal of the trust will be distributed to the American Institute for Cancer Research. The daughter is 48 years of age when the trust is created. The client's wife is 70.

The value of the remainder interest given to the Institute is approximately $43,000. The value of the joint and survivor interest given to the client's wife is about $70,000 and the value of the successor interest given to the daughter is approximately $42,000.

The client reports a gift to the Institute of $43,000 and claims a gift tax charitable deduction for the full value of that gift. The client reports a gift of $70,000 to his wife but because the trust names a noncharitable beneficiary other than the client and his wife, the gift to the wife will not qualify for a marital deduction. It will, however, qualify for an annual exclusion. He also reports a gift of $42,000 to his daughter. Because this is not a present interest, no annual exclusion is available. The end result, assuming no gift splitting: taxable gifts of $57,000 ($70,000 – $13,000 annual exclusion) and $42,000.

Assuming the client has not used his gift tax credit, there will be no actual gift tax liability but, at his death, the taxable gifts will be added to his estate for federal estate tax purposes.

*Note:* The gift values are based on an assumed interest rate of 3% and quarterly payments of the unitrust amounts.

***The Gift Planning Office of the American Institute for Cancer Research will be pleased to help provide the income tax, gift tax and estate tax consequences of any trust for the Institute a client may want to consider. Please call our offices at (800) 843-8114.***

## Gift Tax Marital Deduction

Many charitable remainder trusts provide for annuity or unitrust amount payments to be made to the donor and spouse until the death of both. A special provision of the gift tax law allows a marital deduction for the interest given to the spouse of the donor provided the donor and spouse are the only noncharitable beneficiaries of the trust. This is so whether the spouse is given a concurrent and survivor interest or only a survivor interest.

Trusts funded with jointly owned property or community property can produce different gift tax consequences, depending on whether each spouse is to receive concurrent and survivor interest or consecutive interests and depending on their respective ages. But because a marital deduction will generally shelter any gift from one spouse to the other, there will be no problem of a taxable gift.

## Power of Revocation Avoids Gift Taxes

A client creating a charitable remainder trust for himself or herself, and for other beneficiaries, can avoid any taxable gift by retaining the right, through his or her will, to revoke the annuity or unitrust interest given to the other beneficiaries. The retention of this power will make the gift incomplete for federal gift tax purposes. If the beneficiary dies before the donor, there may be no transfer tax consequences at all.

In the previous example, the client could have avoided any gift to his daughter by reserving, in the trust agreement, the testamentary right to revoke her interest. The retention of a right of revocation will, however, make the full value of the trust includable in the client's estate. (This would happen anyway, in our example, because the client had reserved the right to receive an income for life.)

Retaining a right of revocation will not increase the allowable charitable deduction. The law assumes that the client will not exercise the retained power.

The tax effect of a retained power to revoke an annuity or unitrust interest that is concurrent with the interest of the donor (*e.g.*, the right of the donor's spouse to an equal share of the unitrust amount during their joint lives) is uncertain. Some experts feel that there will be a completed gift of the right to receive the annuity or unitrust amount during the life of the client that must be reported for gift tax purposes (only the value of the survivorship interest is an incomplete gift). Other experts feel there will be no completed gift in the year the trust is funded but that there will be a completed gift each year measured by the amount the spouse actually receives during the year.

## Federal Estate Tax Consequences of an Inter Vivos Charitable Remainder Trust

**Donor Has No Interest.** Property sold, transferred or given away during life will not be part of the donor's gross estate at his or her death unless the donor has retained either an income right or some form of control over the property or the disposition of the property that will cause the trust to be included in the gross estate. (There are other situations where property not owned by a person at death will be included in the estate, but they are not pertinent to our discussion.)

Clearly, a charitable remainder trust that names family members other than the donor as the income beneficiaries and the American Institute for Cancer Research as the remainder beneficiary will not be part of the client's gross estate at his or her death. (As noted above, if the trust results in a taxable gift, the value of the taxable gift will be added to the value of the estate in computing the estate tax liability.)

*Example:* Robert, at age 70, transfers property worth $200,000 to a charitable remainder unitrust that will pay a specified percentage of the value of the trust assets to his son every year for as long as the son may live. No part of the value of the trust will be includable in the gross estate of the donor at his death. But the present value of the son's income interest, reported on a federal gift tax return, less an annual exclusion, will be an "adjusted taxable gift" that must be added to the value of the donor's estate in computing the federal estate tax.

**Donor Has a Reserved Interest.** If an individual creates a charitable remainder trust and names himself as a beneficiary of the annuity or unitrust amount, in general, the entire value of the trust assets as of the date of his death, or a portion of such value, will be includible in his gross estate under Code §2036(a).

Proposed Reg. §20.2036-1 provides guidance on the portion of a charitable remainder trust includible in grantor's gross estate under Code §§2036 and 2039 if the grantor retained an annuity or unitrust interest in the trust.

The proposed regulations provide that the portion of the trust corpus included in the decedent's gross estate is that portion of the trust corpus, valued as of the date of death or alternate valuation date necessary to yield the annual payment using the appropriate §7520 rate in effect on the date of death or alternate valuation date.

In the case of a charitable remainder unitrust, the proposed regulations give the example of a 6% unitrust payable quarterly to the decedent for life and then to the child for life. At the decedent's death, the child is age 55, the value of the trust's assets is $300,000 and the §7520 rate is 4%. The amount of corpus necessary to yield the unitrust payments is determined by dividing the trust's equivalent income interest rate by the §7520 rate. Equivalent income interest rate is determined by dividing the trust's adjusted payment rate by the excess of 1 over the adjusted payout rate. In this case, the appropriate adjusted payout rate is 5.855%

(6% x .975844), making the equivalent income interest rate 6.219% [5.855%/(1 - 5.855%)]. Because this exceeds 100%, the decedent has effectively retained the income from all the assets transferred to trust. Therefore, the entire corpus is included in the gross estate under Code §2036(a)(1), although the estate is entitled to a charitable deduction for the present value of the remainder interest – $79,530.

## The Estate Tax Charitable Deduction

In all cases where the value of a charitable remainder trust is includable in the gross estate of the donor, the present value of the charitable remainder interest at the death of the donor will qualify for an estate tax charitable deduction.

If the donor is the only annuity or unitrust beneficiary, the value of the deduction will be the full value of the trust. In that case, no part of the property transferred to the charitable remainder trust will be taxed in the donor's estate. (And as indicated above, there will be no taxable gift.)

If there is a successor beneficiary of the annuity or unitrust amount, the estate tax charitable deduction (the value of the remainder interest as of the donor's death) will be less than the value of the trust and, unless the value of the interest of the successor beneficiary qualifies for a marital deduction, a portion of the trust will be taxed at the donor's death.

*Example:* A client transfers property worth $200,000 to a charitable remainder unitrust that will pay him 6% a year for as long as he may live and then pay the same amount to his daughter for as long as she may live. The client is 76 years old and the daughter is 56 years of age. (The assumed interest rate for the trust is 3.0%.)

If the client does not reserve a power of revocation, he will make a gift to his daughter of approximately $64,000. Because the gift is not a present interest, the full value will be a taxable gift. The trust will also be part of the donor's gross estate for federal estate tax purposes (and subject to adjustment to reflect the earlier taxable gift).

If the client reserves the right to revoke, there will be no completed gift for federal gift tax purposes. But whether or not the client reserves the right to revoke, the value of the trust at the time of the client's death will be includable in his gross estate and the date of death value of the remainder interest given to the American Institute for Cancer Research will qualify for an estate tax charitable deduction. Of course, there will be no "taxable gift" to the extent the value of the gift is includable in the gross estate of the client.

## Generation Skipping Transfer Tax on a Charitable Remainder Trust

In 1986, Congress passed a complex law designed to prevent individuals from avoiding successive estate taxes in passing wealth from one generation to another. It is aptly called the generation skipping transfer tax because it imposes a special tax on property transferred to persons more than one generation removed from the donor's generation (*e.g.*, the tax is imposed on transfers an individual makes to grandchildren or great-grandchildren).

Property transferred to a charitable remainder trust that names grandchildren or great-grandchildren as beneficiaries will be subject to this tax. Unlike direct gifts to grandchildren where the present value of the gift is taxed and the generation skipping tax is paid by the donor, there is no immediate tax when the charitable remainder trust is created. However, the annuity or unitrust amount paid each year to the grandchildren will be subject to the generation skipping transfer tax.

A generation skipping transfer tax exemption equal to the amount sheltered from federal estate tax is available to every individual and can be allocated to gifts made during life or to transfers made at death. In many cases, this exemption will prevent any generation skipping transfer tax liability.

*Example:* A client transfers $200,000 to a charitable remainder unitrust that will pay 6% of the value of the trust to his grandson every year for 20 years. The property will be distributed to the American Institute for Cancer Research at the end of the 20-year period. There is no "direct gift" for generation skipping tax purposes because the Institute is not a "skip person." But the unitrust amount paid to the grandson every year will be subject to the generation skipping tax at a rate that is based on the highest gift tax rate but reduced under a formula that takes the charitable deduction into consideration.

The tax is paid by the grandson and not by the trust. (It would be prudent to provide specifically in the trust instrument that the beneficiary is solely liable for the payment of any generation skipping transfer tax.)

The client can avoid this tax by allocating so much of his generation skipping transfer tax exemption to the charitable remainder trust that is equal to the present value of the income interest given to the grandson.

## Transfer Tax Results of Charitable Remainder Trusts

| Donor Creates Lifetime Trust Paying Income to: | Taxable Gift? | Annual Gift Tax Exclusion? | Marital Deduction? | Included in Gross Estate? |
|---|---|---|---|---|
| 1. Self for life | No | N/A | N/A | Yes, but 100% charitable deduction |
| 2. Spouse for life | No | N/A | Yes | No |
| 3. Self and spouse for life | No | N/A | Yes | Yes, but 100% marital deduction |
| 4. Spouse and then to third person for life | Yes | Yes, but only for the gift to the spouse | No | No. Adjusted taxable gift is added back |
| 5. Non-spouse for life, no right to revoke in will reserved | Yes | Yes | No | No. Adjusted taxable gift is added back |
| 6. Self, then to non-spouse without right to revoke by will reserved | Yes | No (gift of future interest) | No | Yes, but charitable deduction for date of death remainder value |
| 7. Self, then to non-spouse reserving right to revoke by will | No (gift incomplete) | N/A | No | Yes, but charitable deduction based on date of death remainder value |
| 8. Self and non-spouse as joint and survivor beneficiaries, no right to revoke by will reserved | Yes | Yes | No | Yes, but charitable deduction based on age at donor's death |
| 9. Non-spouse for life, reserving right to revoke by will (revocation should be a "qualified contingency" under Code §664(f)(2)) | Probably, as to annual payments, uncertain as to income interest | Yes, for annual payments | No | Yes, but charitable deduction based on age at donor's death |
| 10. Non-spouse for term of years with right to revoke by will | Annual payments taxed | Yes, for annual payments | No | Yes, but charitable deduction based on remainder value at donor's death |
| 11. Non-spouse for term of years, no right to revoke in will | Yes, on value of income interest | Yes | No | No. Adjusted taxable gift is added back |

# BASIC TRANSFER TAX CONSEQUENCES OF A CHARITABLE LEAD TRUST

## Federal Gift Tax Consequences of an Inter Vivos Lead Trust

Every qualified charitable lead trust must provide for at least two basic gifts. The first gift is the payment of an annuity or unitrust amount to a qualified charitable organization (such as the American Institute for Cancer Research) every year for a specified term of years (or for the lives of one or more individuals). The second basic gift is the payment of the principal of the trust to the donor or to designated individual beneficiaries when the charitable payments terminate.

The gift tax consequences are simple and direct. The present value of the annuity or unitrust interest given to the Institute (or other qualified charity) is a reportable gift, but the full value of the gift qualifies for a gift tax charitable deduction.

If the donor names himself or herself as the sole remainder beneficiary, the gift to the Institute is the only gift. And, because that gift is offset by the charitable deduction, there is no taxable gift.

In most cases, the donor will name family members or other individuals as remainder beneficiaries. Clearly there is a gift to each of the remaindermen. Each gift must be reported for gift tax purposes. Because the gifts are not present interests, annual exclusions are not available.

*Example:* A client transfers $500,000 to a charitable lead trust that will pay $20,000 to the American Institute for Cancer Research every year for the next 15 years. At the end of the 15 years, the principal of the trust is to be distributed, in equal shares, to her three children. The interest given to the Institute has a present value of approximately $240,000 (3.0% A.F.R.) and this full value qualifies for a gift tax charitable deduction. The value of the remainder interest is about $260,000, so the value of the interest given to each child is $86,667. No annual exclusions are allowable.

The donor's gift tax credit could avoid any immediate gift tax liability. But at the donor's death, the taxable gifts of $260,000 will be added to the value of her estate for purposes of determining estate tax liability.

Appreciation in the value of the property transferred to the lead trust will, of course, be free of all gift and estate taxes.

A lifetime charitable lead trust can "leverage" the gift tax exemption into $5 million, $10 million or even more, depending on the payout to charity and the number of years the trust lasts, or even "zero out" gift taxes.

Take the case of Mr. and Mrs. H, both in their mid-60s, who own $50 million of assets between them. They have three children who are in their late 30s, whom they wish to benefit. Mr. and Mrs. H would also like to make a major contribution to the war against cancer. They decide to transfer $10 million to a charitable lead annuity trust that will pay $400,000 a year to the American Institute for Cancer Research for 26 years, after which the trust assets, plus any appreciation, will pass to their children. Tax results? The future gift to the children is reduced to about $2 million, which will be sheltered by applying each spouse's gift tax credit. If the trust grows to, say, $15 million, no further gift or estate tax will be due. None of the trust income will be taxable to Mr. and Mrs. H, saving them considerable income taxes annually. But most satisfying is that $10.4 million will be distributed for cancer research during the trust term. Note: At a 2.0% A.F.R., the couple can reduce the taxable gift to zero by increasing the payout to $500,000 annually.

***We invite you to call our Gift Planning Office if you would like to know the gift and estate tax consequences of any lead trust a client may want to consider to benefit the war against cancer. Our toll-free number is (800) 843-8114.***

## Generation Skipping Transfer Tax for Charitable Lead Trusts

A client is free to name anyone he or she wishes as the remainder beneficiaries of a charitable lead trust. If the remainder beneficiaries named by the client are more than one generation removed from the client (*e.g.*, they are grandchildren or great-grandchildren of the client), the trust will have generation skipping transfer tax consequences. And the tax consequences will differ, depending on whether the trust is a lead annuity trust or a lead unitrust.

**Charitable Lead Unitrust.** There is no "direct gift" to the remainder beneficiaries when a charitable lead unitrust is created. However, a taxable termination occurs at the time the unitrust payments to charity end and the principal is to be distributed to the remainder beneficiaries. The value of the remainder interest will be subject to the generation skipping transfer tax at a rate that is based on a special "inclusion ratio." The tax is paid by the trust prior to distributing the trust assets to the remaindermen.

The generation skipping tax on an inter vivos charitable lead unitrust can be avoided by allocating to the trust an amount of the client's generation skipping transfer tax exemption that is equal to the present value of the remainder interest at the time the gift is made. Even though the value of the trust assets increases during the time the unitrust amounts are paid to charity, the allocation of the initial present value of the remainder interest will avoid any tax.

If the above example were a $500,000 lead unitrust with grandchildren as remainder beneficiaries, and the value of the remainder interest at the time of the gift was approximately $300,000, there would be no generation skipping transfer tax, even if the amount distributable to the remainder beneficiaries grew to $2,000,000, if the donor allocated $300,000 of his exemption to the trust. (The allocation is made in the gift tax return reporting the gift to the lead trust.)

**Charitable Lead Annuity Trust.** The charitable lead annuity trust does not have the certain generation skipping transfer tax consequences that a unitrust has because the "inclusion ratio" formula is based on the actual value of the trust at the time it is distributed rather than on the initial present value of the remainder interest. The generation skipping tax exemption allocated to the gift is increased for the charitable term of the trust at the IRS discount rate applicable to the gift. The increased exemption is then applied to the value of the trust at the end of the charitable period.

*Alert:* Clearly, a lead annuity trust for the lifetime of an individual can produce very harsh and unfair generation skipping transfer tax consequences if the measuring life ends long before his or her normal life expectancy.

## Federal Estate Tax Consequences of a Charitable Lead Trust

A charitable lead trust created during the life of a client will not be includable in the client's gross estate unless he or she has retained a reversionary interest or retained the right to change the beneficiaries or a power to control the income, principal or administration of the trust.

The typical inter vivos lead trust created for estate planning purposes will name the American Institute for Cancer Research (or other qualified charitable organization) as the income beneficiary and family members as the remainder beneficiaries. One or more family members will serve as trustee, or an independent trustee may be named. With this typical trust arrangement, the value of the trust will not be part of the donor's gross estate.

Of course, the present value of the remainder interest will be an "adjusted taxable gift" and will be added to the value of the donor's estate in computing the federal estate tax liability at the death of the donor.

Post-gift appreciation in the value of the trust assets will not be subject to gift or estate taxes.

A testamentary lead trust is includable in the client's gross estate but an estate tax charitable deduction is allowed for the value of the annuity or unitrust interest given to the American Institute for Cancer Research or other qualified charity.

# PLANNING A CHARITABLE TRUST AS PART OF A CLIENT'S ESTATE DISTRIBUTION

This portion of the booklet will discuss some of the particular charitable remainder trust or charitable lead trust arrangements that can be most helpful in carrying out a client's estate objectives.

The specific objectives of a client will usually determine whether a charitable remainder trust or a charitable lead trust should be part of the estate plan – although there are situations where a combination remainder trust and a lead trust will best accomplish the objectives of your client.

## A Charitable Remainder Trust in a Client's Estate Plan

A charitable remainder trust will be most attractive to those clients who want to provide a high and dependable lifetime income for family members – rather than a single lump sum amount – as well as future support for important cancer prevention research and education programs that may help future generations avoid the terrible tragedy of cancer.

A charitable remainder trust can significantly minimize estate taxes and, if created during life, it can give rise to an immediate income tax charitable deduction. Avoiding income taxes at death on retirement plan distributions, U.S. savings bonds and other properties that would produce income in respect of a decedent may be another important consideration for some clients.

**Choosing an Annuity Trust or a Unitrust.** A charitable remainder annuity trust created for family members will provide them with an annual fixed dollar amount that can never change. A unitrust, on the other hand, will provide an annual income that will vary from year to year with the economy and the investment success of the trust.

In an inflationary economy, a charitable remainder unitrust may be preferable unless the beneficiaries are quite old or the trust is to last for a relatively short number of years.

If the trust is to be created during life and funded more substantially at the death of the client (often with retirement benefits or other properties that would be income in respect of a decedent), a unitrust must be used because additional contributions can never be made to a charitable remainder annuity trust.

The amount of the allowable charitable deduction (for income, gift and estate tax purposes) can sometimes be a factor in deciding whether to create an annuity trust or a unitrust as part of a client's estate plan. If the payout to family members is to be lower than the assumed interest rate of the trust (*i.e.*, a 5% annuity or unitrust amount and a 6% assumed interest rate), an annuity trust will provide the largest charitable deduction. And if the payout rate will be larger than the assumed interest rate (*i.e.*, an annuity or unitrust amount of 5% and a 3% assumed interest rate), a unitrust will provide the largest charitable deduction.

With either form of trust (especially a testamentary trust), the trustee may be able to invest the trust assets in a way that will make the annuity or unitrust payments partly or wholly tax free to the beneficiaries, or taxed as capital gain.

If the beneficiaries already have an adequate current income and are in a high income tax bracket, it may be wise to provide the opportunity to defer annual payments to the beneficiaries and, at the same time, build a very high retirement income for them. This can be accomplished through an income-only unitrust with make-up provisions or a "flip" unitrust.

**Inter Vivos or Testamentary Trust.** Creating a charitable remainder trust for family members during life, rather than at death, has the obvious advantage of providing an income tax charitable deduction for the client. An inter vivos trust also permits post-gift appreciation in the value of trust assets to provide a higher income for family members and to pass to the American Institute for Cancer Research wholly free of gift and estate taxes. And in large estates, deliberately incurring a gift tax (with an inter vivos trust) can be considerably less expensive than incurring an estate tax (with a testamentary trust).

A possible advantage of a testamentary trust is that the trust will take a stepped-up cost basis in the properties it receives from the estate. This can make it possible to provide a tax free or favorably taxed income to the income beneficiaries.

Perhaps the most rewarding plan is to create a charitable remainder unitrust during life. The trustee will be directed to pay the unitrust amount to the client for life and, after the death of the client, to make the unitrust payments to designated family members for their lives or for a period of years. The client may want to avoid any gift tax liability by reserving the right, through his or her will, to revoke the interests given to family members. The trust can permit additional contributions and, in appropriate cases, the client can name the trust as the beneficiary of retirement plan accounts and other properties that would be taxed to beneficiaries – other than a charitable remainder trust – as income in respect of a decedent.

## Wealth Replacement Planning with a Charitable Remainder Trust

A client can transfer property to a charitable remainder trust that will pay a good income for life and pass to the American Institute for Cancer Research at his or her death (or at the death of the donor and spouse). There will be absolutely no gift or estate tax cost because of the allowable charitable deduction. But, of course, the property transferred to the charitable remainder trust will not be available to the donor's family or other beneficiaries.

The client may want to replace the property transferred to the trust. This can be accomplished by giving the income tax savings resulting from the charitable remainder trust and/or part of the higher income received from the trust, to family members – or to a separate trust – that will purchase insurance on the life of the donor (or a survivor policy on the life of the donor and spouse). With careful planning, the life insurance received by family members will be completely free of income, gift and estate taxes.

If your client has a taxable estate, transferring $500,000 to a charitable remainder trust (that will pay an income for life) and using the income tax savings to purchase life insurance for family members (planned so as to be free of gift and estate taxes) can significantly reduce the federal estate tax liability at the client's death.

## A Charitable Lead Trust in a Client's Estate Plan

The charitable lead trust, with its unique ability to minimize federal estate taxes, is most suitable for those clients who have substantial estates and who want to benefit the war against cancer as well as provide for family members or other beneficiaries. In most cases, the lead trust will be appropriate only where the client's intended beneficiaries have sufficient wealth that delaying a distribution to them will not create any financial problems.

The particular assets owned by the client will often make a charitable lead trust more or less attractive in the client's estate planning. For example, a lead trust may be an excellent arrangement for passing a farm or closely held business interest to family members, provided the farm or business produces an income that is adequate to make the annuity or unitrust amount payments to the designated charities.

An asset with a present discounted value (*e.g.*, a minority interest in a family partnership) that is likely to appreciate substantially in value may also be a good asset to transfer to an inter vivos charitable lead trust.

**Choosing an Annuity Trust or Unitrust.** A qualified charitable lead trust must provide for the payment to one or more charitable organizations, at least annually, of a fixed dollar amount (an annuity trust) or a specified percentage of the value of the trust in that year (a unitrust).

In many cases, the choice between an annuity trust and a unitrust will come down to which trust form will provide the largest benefits to family members or other beneficiaries. An annuity trust will provide the greatest benefits for family members if the trust is expected to have income or growth in excess of the annuity amount. On the other hand, a unitrust that expects to have growth in excess of the specified unitrust amount percentage will be preferable if the client wants to provide maximum benefits for the designated charitable beneficiary or beneficiaries.

The allowable gift or estate tax charitable deduction may be another factor in deciding between a lead annuity trust and a lead unitrust. The annuity trust will produce the largest charitable deduction if the assumed interest rate (120% of the applicable federal midterm interest rate) is less than the payout rate. If the desired payout rate is less than the assumed interest rate, the lead unitrust will produce the higher charitable deduction.

Over the years, it seems that the lead annuity trust has been more popular than the lead unitrust. Additional contributions cannot be made to an annuity trust, but this is generally not an important consideration. If the remaindermen are grandchildren or great-grandchildren of the donor, a unitrust may be preferred because any possibility of a generation skipping transfer tax can be avoided by allocating to the trust an amount of the donor's exemption equal to the present value of the remainder interest. This kind of certainty is not possible with a charitable lead annuity trust.

We need to mention that an income only unitrust – a popular charitable remainder trust arrangement – cannot be used with a lead trust. The payment of the specified percentage of value to the designated charitable beneficiaries must be absolute and unconditional.

**Choosing an Inter Vivos or Testamentary Trust.** There are advantages and disadvantages to both the inter vivos lead trust and the testamentary lead trust. The inter vivos trust will shelter post-gift appreciation in value from gift and estate taxes. It will remove not only the gift property from the donor's estate but also income that would have been earned on the property prior to the donor's death. But property transferred to an inter vivos lead trust will take the donor's cost basis and that basis will carry over to the remainder beneficiaries of the trust.

There is another important advantage of an inter vivos lead trust created for the immediate benefit of the American Institute for Cancer Research. The donor will have the satisfaction of seeing how his or her annual trust gifts are: (a) adding to our knowledge of how cancer can be effectively treated and prevented and (b) helping the Institute inform millions of people about the importance of diet and lifestyle in avoiding the tragedy of cancer.

**Funding a Charitable Lead Trust.** Just about any type of property can be transferred to a charitable lead trust. Property that is likely to appreciate in value but has not already appreciated in value seems to be an ideal property to transfer to a charitable lead trust.

Transferring appreciated property to an inter vivos lead trust does not trigger a capital gains tax. But the trust will take the donor's cost basis and it will incur a capital gains tax when it sells the property. And if the trust does not sell the property, the donor's cost basis will pass to the remainder beneficiaries who will have to pay a capital gains tax when they sell the property.

In most cases, a lead trust should be funded with property that will produce an income or readily marketable gains equal to or larger than the annuity or unitrust amount payable to the charitable beneficiaries. This can be especially important if the client wants to use the lead trust to eventually pass a farm or closely held business to family members. Care should be taken to avoid the need for an excess business holding prohibition by limiting the present value of the charitable interest to no more than 60% of the value of the trust.

**A Grantor Trust Should Be Considered.** A client creating a charitable lead trust will generally have the option of creating a grantor lead trust or a non-grantor lead trust. Essentially, a grantor trust gives the remainder interest to the donor whereas a non-grantor trust gives the remainder interest to family or other beneficiaries.

The typical lead trust created as part of a client's estate plan will be a non-grantor trust. (This is the type of trust we have been discussing in this section.) The income and capital gains earned by the trust, less the amounts distributed to the charitable beneficiaries, will be taxable to the trust. No part of the income will be taxable to the donor-client, and at the donor's death, the value of the trust will not be part of the gross estate for federal estate tax purposes. Of course, if the creation of the trust was a "taxable gift," the amount of the "taxable gift" will be added to the value of the client's estate for purposes of computing the estate tax liability.

In some cases, it may be advantageous to include in the non-grantor trust agreement one of the many provisions that will make the income and gains of the trust taxable to the donor, but will not make the trust subject to the federal estate tax at the donor's death.

In this case, an immediate income tax deduction will be allowed for the present value of the charitable annuity or unitrust amount, but all the income earned by the trust will be taxable to the donor. This arrangement can be attractive if the client expects to be in a low income tax bracket in future years or if the trust will invest in a way that produces little or no taxable income (*e.g.*, investing in municipal bonds) or favorably taxed long-term capital gains.

**Designating the Charitable Beneficiaries.** A charitable lead trust can name the American Institute for Cancer Research as the sole beneficiary of the annuity or unitrust payments, or it can name several charitable organizations as the income beneficiaries. The designated charities must, of course, be qualified under the pertinent income tax, gift tax and estate tax provisions. The client cannot reserve the right to name the charitable beneficiaries (or change the beneficiaries), but an independent trustee can be given discretion to make the annuity or unitrust amount payments to whatever qualified charitable organizations it may select.

The American Institute for Cancer Research is a fully qualified charitable organization. The maximum income tax, gift tax and estate tax benefits will be allowed when the Institute is named to receive the annuity or unitrust payments. And, of course, if your client wishes, the payments to the Institute can be restricted to a particular research or educational program of special interest to the client.

Please feel free to call us at (800) 843-8114 to find out about the research or educational programs we are now supporting, suggestions for restricted, endowment or memorial gifts or for more information about the planning or drafting of a charitable lead trust or charitable remainder trust.

### Charitable QTIP Trusts for Married Couples

A qualified terminable interest property (QTIP) trust with charity as remainderman can generate a 100% estate tax marital deduction when the first spouse dies and a 100% estate tax charitable deduction at the death of the surviving spouse. This is a simple, flexible arrangement that permits a person to provide for a spouse, yet ultimately pass part or even all of the estate to charity.

Among other things, QTIP trusts are required to pay all trust income, at least once a year, to a surviving spouse, and no other person can be an income beneficiary. Such a trust would not be a qualified charitable remainder trust, in which payments are made as unitrust or annuity payouts. But a charitable deduction would be unnecessary because the trust would qualify for the unlimited estate tax marital deduction. Would spouses ever want to establish testamentary qualified remainder trusts for a surviving spouse? The answer is yes – if there are to be income beneficiaries in addition to the surviving spouse. Such a trust would fail as a QTIP trust, but could nonetheless generate an estate tax charitable deduction. Additionally, since qualified CRTs are generally exempt from income taxes, they can be funded with IRAs, savings bonds or other income in respect of a decedent, which the trustee can liquidate without tax.

A testamentary charitable remainder unitrust for a surviving spouse also might make sense if the survivor wanted to use the trust as a philanthropic vehicle. The spouse could make additional contributions to the unitrust, realize income tax and capital gains tax savings, and provide further benefit to the charitable remainderman.

A private letter ruling permitted a spouse to bequeath property to a QTIP trust that pays the surviving spouse income for life, then empties into a charitable remainder trust for children. The estate of the first spouse to die qualifies for the marital deduction, assuming the executor makes a timely QTIP election. The surviving spouse's estate will include the value of the assets passing to the charitable remainder trust – but the estate will qualify for a charitable deduction equal to charity's remainder interest. The same technique reasonably should apply to a charitable lead trust.

## CHARITABLE TRUST PLANNING FOR CLIENTS WHO WON'T FACE ESTATE TAXES

Donors who wish to benefit charities and family members using the same assets may continue to be attracted to charitable remainder trusts because of the money management or fiduciary services these vehicles provide to beneficiaries. If gift arrangements are established during life, they also avoid probate. Charitable remainder trusts could provide lifetime income to family beneficiaries without income tax erosion from IRD taxes. Donors would still be encouraged to bequeath IRAs and savings bonds to charitable organizations.

State death taxes may be a continuing problem in many areas. Deductions are available for charitable bequests, including bequests in trust, in most states that have inheritance or estate taxes.

## The War Against Cancer

When you have the occasion to draft a trust or a bequest for a client who wants part of his or her estate to support the war against cancer, our correct legal name is:

"The American Institute for Cancer Research, a not-for-profit corporation located in Washington, DC."

Please feel free to contact our Gift Planning Office for additional information about the mission and the future plans of the American Institute for Cancer Research.

Our Gift Planning Office will be pleased to help you plan a trust or bequest that will accomplish the specific objectives of your client. We can also provide the exact tax consequences of any trust arrangement a client may want to consider. There is no other obligation for this service.

## Information for the Attorney or Advisor

- AICR's official name:
  American Institute for Cancer Research
- AICR's mailing address:
  1560 Wilson Blvd, Suite 1000,
  Arlington, VA 22209
- AICR's phone number:
  800-843-8114
- AICR's identification:
  A not-for-profit organization under Section 501(c)(3)
  of the Internal Revenue Service Code
- AICR's tax-exempt IRS number:
  52-1238026

The information and examples provided in this booklet are for information and discussion purposes only. The examples are hypothetical, and the facts and tax consequences of individual transactions may vary from person to person. Each estate planning professional must independently determine and evaluate the tax and financial consequences of each individual situation.

**Gift Planning Office**

**American Institute for Cancer Research**

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**800-843-8114**

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