Split-Interest Charitable Giving Techniques

in brief

Northwestern Mutual®

Summary of Split-Interest Charitable Giving Techniques

Charitable Remainder Trust

- Allows the donor to provide a gift to charity (i.e., the remainder interest) while reserving an income stream personally or for any other non-charitable beneficiary.
- The trust can sell appreciated property without currently recognizing gain. This allows the trust to reinvest the entire sale proceeds.
- If the donor creates and funds the trust during his lifetime, the donor receives a current charitable income tax deduction for the present value of the remainder interest passing to charity at the end of the trust term.
- In most situations, the property is not subject to tax in the donor's estate.

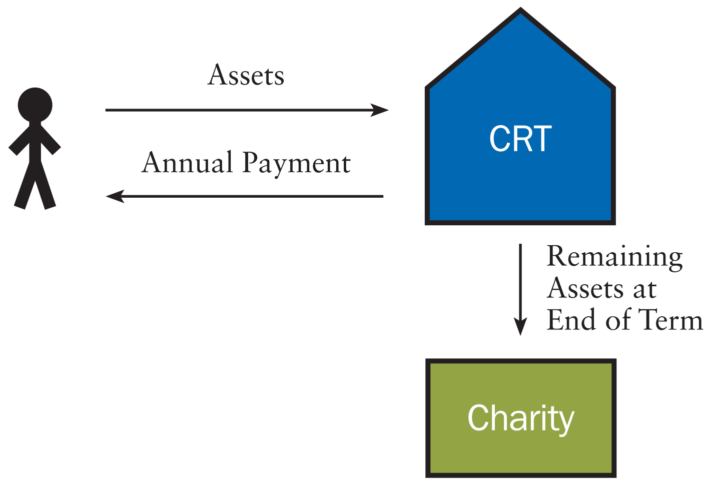
Charitable Gift Annuity

- Allows the donor to provide a gift to charity in exchange for a lifetime annuity.
- Creates a current charitable income tax deduction for the value of the gift less the present value of the annuity payments.
- The contributed property is not included in the donor's gross estate.
- Specified annual amount is paid by the charity to donor or donor's designee for life. Can also be paid for the joint lives of the donor and another person.
- Lower administrative cost for the donor than a charitable remainder trust.

Charitable Lead Trust

- Allows the donor to provide a gift to charity (i.e., the lead interest) while naming himself or someone else (such as family members) as the remainder beneficiary.
- In some situations, creates a current charitable income tax deduction.
- For gift or estate tax purposes, the value of the property transferred to the trust is reduced by the value of the charitable lead interest.
- Certain types of charitable lead trusts can be an effective way to preserve the contributed assets for future generations.

Charitable Remainder Trusts



Mechanics

- Donor creates an irrevocable charitable remainder trust (CRT). The CRT can be funded during the donor's lifetime or at the donor's death. Either the donor or the donor's designated beneficiaries receive annual payments from the CRT for a specified term of years or for life.
- The CRT can either be an annuity trust or a unitrust. An annuity trust pays a fixed amount, stated in the trust either as a dollar amount or as a fixed percentage (not less than 5%, not more than 50%) of the initial fair market value of the CRT assets. A unitrust pays a fixed percentage (not less than 5%, not more than 50%) of the CRT assets valued annually.
- The CRT must make payments at least annually, and at least one income beneficiary must not be a charity.
- Additional contributions may be made to a unitrust, but not to an annuity trust.
- At the expiration of the term of the trust, the remainder must be paid to the charity or charities designated in the CRT document. The donor may reserve the right to change the charitable remainder beneficiaries.

Charitable Remainder Trusts (continued)

Income tax consequences:

- Donor receives an income tax charitable deduction equal to the present value of the remainder interest passing to charity. See Treas. Reg. § 1.664-4(a). This must be at least 10% of the initial value of each gift to the CRT.
- CRT distributions are taxed to the income beneficiaries to the extent the trust has income in the current year or undistributed income from prior years. The distributions are taxed to the income beneficiaries in the following order:
  – ordinary income;
  – capital gains;
  – tax-exempt income; and
  – corpus. See Internal Revenue Code § 664(b).
- CRTs are tax-exempt trusts. See I.R.C. § 664(c).

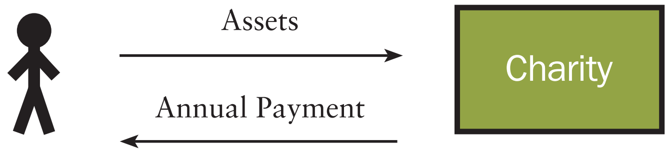
Gift tax consequences:

- If the donor creates an income interest in a non-charitable beneficiary other than the donor, there is a taxable gift.
- If the non-charitable beneficiary's interest begins in the future, the donor may retain the right to revoke the beneficiary's interest. In this case, there is no current gift.
- Donor receives a gift tax charitable deduction for the present value of the remainder interest. I.R.C. § 2522(c)(2)(A).

Estate tax consequences:

- The CRT value is included in the donor's gross estate if the right to receive an amount from the CRT existed at death or was relinquished within three years of death. This inclusion will be offset, at least partially, by the estate tax charitable deduction for the value passing to charity. See I.R.C. § 2055(e)(2)(A).

Charitable Gift Annuities



Mechanics

- Charity must first establish a gift annuity program that complies with any state insurance and securities regulations.
- Charity executes an annuity agreement promising to pay the donor (or other designated person) an annuity for life in exchange for a gift of cash or property.
- Donor transfers the cash or property (often appreciated) to the charity.
- The amount of each annuity payment depends upon the value of the property transferred, the annuity rate, and the age of the annuity recipient.
- Generally, the value of the annuity is less than the cash or property donated.

Income tax consequences

- Donor receives a current income tax charitable deduction equal to the total contribution of cash or property transferred to the charity less the present value of the annuity. The I.R.S. publishes rate tables used to determine the annuity value.
- The normal annuity rules apply if the donor exchanges cash or nonappreciated property for the annuity. See I.R.C. §72. If appreciated property is exchanged for the annuity, a portion of each annuity payment that would otherwise be tax-free return of principal is recharacterized as gain. See I.R.C. § 1011.

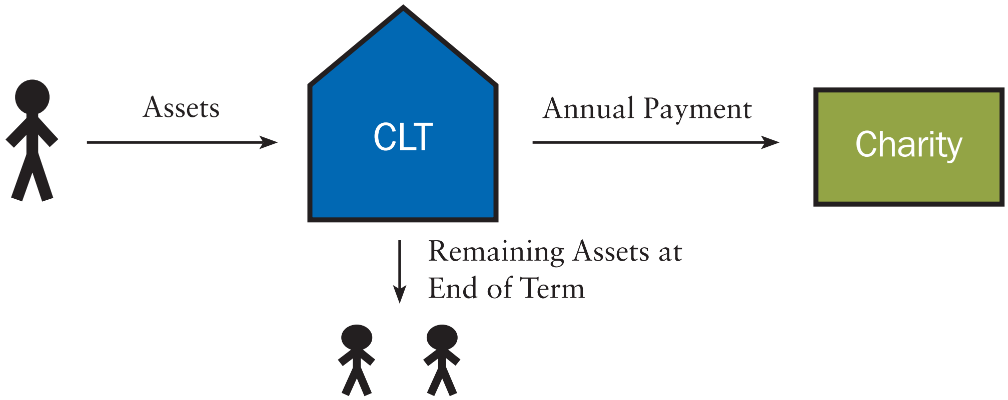
Gift tax consequences

- As with a CRT, if the donor names someone else to receive annuity payments, the donor has made a gift.
- Donor receives a gift tax charitable deduction equal to the fair market value of the contributed property less the present value of the annuity received.

Estate tax consequences

- Nothing is included in the donor's estate if the donor is the sole annuitant.
- If a joint and survivor annuity is created, the value of the survivor's annuity is included in the donor's gross estate. The unlimited marital deduction is available for survivor annuity interests payable to U.S. citizen spouses.

Charitable Lead Trusts



Mechanics

- Donor creates an irrevocable charitable lead trust (CLT) which provides that a payment (i.e., the lead interest) is made at least annually to the designated charity or charities for a specified term.
- The CLT can either be an annuity trust or a unitrust. An annuity trust pays a fixed amount, either a dollar amount or a fixed percentage of the initial fair market value of the CLT assets. A unitrust pays a fixed percentage of the CLT assets valued annually. Unlike the CRT, there is no minimum or maximum percentage that must be distributed annually.
- The payment period may be for a specific term of years or for the life or lives of an individual or individuals who are living and known on the date of the transfer.
- At the expiration of the payment period, the remainder interest is paid to either the donor or other non-charitable beneficiaries.

Income tax consequences

- Unlike CRTs, CLTs are not tax-exempt. A CLT can be designed as either a grantor trust or a non-grantor trust.
- If the CLT is a grantor trust, the donor receives an income tax charitable deduction equal to the value of the charitable lead interest upon the creation of the trust. See I.R.C. § 170(f)(2)(B). The donor is taxed on all income as it is earned by the trust under the grantor trust rules.
- If the CLT is a non-grantor trust, the donor does not receive an income tax charitable deduction upon the creation of the trust. As a separate tax-paying entity, the CLT is taxed on all net income as it is earned by the trust. The CLT is allowed a charitable income tax deduction for amounts paid to charity each year. See I.R.C. § 642(c)(1).

Charitable Lead Trusts (continued)

Gift tax consequences

- There is a taxable gift if the remainder beneficiary of a CLT is someone other than the grantor.
- The gift of the remainder interest to a non-charitable beneficiary is a gift of a future interest and does not qualify for the gift tax annual exclusion.
- Donor receives a gift tax charitable deduction for the value of the charitable lead interest. See I.R.C. § 2522(c)(2)(B).

Estate tax consequences

- In general, nothing is included in the donor's estate if the CLT is created during the donor's lifetime. If the intent is for the CLT to be a grantor trust, this can be done by using one of the "defective trust" provisions of I.R.C. §§ 671-679 that do not cause estate inclusion.
- If the CLT is created upon the donor's death, the trust assets are included in his gross estate. The estate is entitled to an estate tax charitable deduction for the value of the charitable lead interest.

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