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Assigning Income to Another Taxpayer Who Pays No Tax on Such Income

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INTRODUCTION

The 2017 tax act,[1] effective for taxable years beginning after December 31, 2017, repealed the deduction for personal exemptions under §151[2] and raised the standard deduction under §63 as follows:

- For married taxpayers filing a joint tax return the standard deduction increased to $24,000 (from $12,700 under prior law);
- For single taxpayers the standard deduction increased to $12,000 (from $6,350 under prior law); and
- For heads of household the standard deduction increased to $18,000 (from $9,350 under prior law).

Consequently, many taxpayers who itemized deductions in previous years will use the standard deduction because the increased standard deduction will exceed their itemized deductions. Such taxpayers will no longer get a tax benefit for their charitable gifts. This article explores a technique that will allow a nongrantor trust to obtain the tax benefit of charitable contributions by using a charitable lead annuity trust (CLAT) notwithstanding the loss of the income tax charitable deduction to the individual who uses the standard deduction.

FACTS

Assume that Fred, a single taxpayer who has gross income of $210,000, traditionally gives $10,000 each year to his favorite charitable organizations. Fred intends to continue such charitable giving. Fred's only other expenses that qualify for an itemized deduction are his state sales tax.[3] The sales tax deduction,[4] when added to his charitable gifts, will no longer exceed the standard deduction under the 2017 tax act. Fred anticipates that his taxable income for the year 2018 will be approximately $198,000 (gross income of $210,000 less his $12,000 standard deduction). His annual tax liability will be approximately $45,050. Fred's assets consist of his personal items and a brokerage account with income-producing assets generating $210,000 of annual income.

Fred approaches his tax adviser and asks whether he can make annual charitable gifts in a tax-efficient manner after the 2017 tax act.

SOLUTION

Charitable lead trusts have been around for many years, but often do not receive the same attention as charitable remainder trusts. One reason for this may be that charitable lead trusts are not exempt from income tax like charitable remainder trusts. During the

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[1] Pub. L. No. 115-97.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

[3] Assume Fred lives in a state with no income taxes. Because Fred pays rent at an independent living facility, he has no mortgage interest and no real estate taxes.

[4] This deduction is still allowed but the $10,000 limit applies. §164(b)(6)(B).

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past several years, with the current low-interest-rate environment, an individual could transfer significant wealth to children without any transfer taxes through a charitable lead trust by leveraging the current low interest rates[5] over a long period of time. This financial leverage occurs when the actual investment rate of return is greater than the §7520 rate the tax law uses for income, estate, and gift tax reporting purposes, and the fact that the compounding of that financial leverage over a long period produces favorable results.

With the enactment of the 2017 tax act, the benefits of charitable lead trusts go beyond leveraging the low §7520 rate for estate planning. In today's tax climate, a taxpayer who makes annual charitable gifts may have lost the ability to deduct such charitable contributions because the increased standard deduction exceeds the itemized deductions. This taxpayer should consider creating a charitable lead annuity trust (CLAT).

CHARITABLE LEAD TRUSTS

A charitable lead trust pays annual amounts to one or more charitable beneficiaries for a specific period of time, and the remainder interest either reverts to the grantor or is distributed to designated non-charitable beneficiaries upon the expiration of the term of the trust. The charitable lead trust works the same way as a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT) except the annual annuity or unitrust interest is given to a charitable organization instead of retained by the trust creator. Because there is no retained annuity or unitrust interest, and if the remainder interest is gifted away at formation, there is no exposure to estate tax inclusion if the creator of the charitable lead trust dies during the term of the trust as there is with a GRAT or GRUT.[6]

As with charitable remainder trusts, the applicable trust agreement must satisfy certain technical requirements in order for the payments to the charitable organizations to qualify for the charitable income, estate, or gift tax deduction.[7] One such requirement for a trust to be a qualifying charitable lead trust is that the annual payment to a charitable organization must be in the form of a guaranteed annuity or a unitrust interest. Only one of such payment methods may be used. A hybrid form of payment is not allowed.

A CLAT directs the trustee to distribute to one or more charitable beneficiaries a fixed sum[8] payable not less than annually during the term of the trust. A charitable lead unitrust (CLUT) directs the trustee to distribute to one or more charitable beneficiaries a fixed percentage of the net fair market value, determined annually, of the trust assets. The term of a charitable lead trust in which the annuity or unitrust interest is paid may be for a specified term of years or for the life or lives of an individual or individuals, provided each individual is living on the date the individual transfers property to the trust. Note that the tax law places no limit on the duration of a charitable lead trust.[9]

The grantor may choose any fixed annuity or unitrust amount to be paid to the designated charitable organizations. Unlike charitable remainder trusts, the 5% minimum annual payment,[10] the 50% maximum annual payment,[11] and the 5% exhaustion requirement[12] do not apply to charitable lead trusts.

The fixed annual charitable payments for a CLAT may be expressed in the trust agreement as a stated percentage of the fair market value of the trust assets as of the date of funding the trust (or the date of death or alternate valuation date with respect to a testamentary trust). Alternatively, the fixed annual charitable payments may be expressed by way of a formula designed to achieve a certain tax result such as arranging, as much as possible, to have the present value of the charitable lead interest equal the fair market value of the assets placed into the trust, thereby achieving a ''zeroed out'' value for the non-charitable remainder interest.

The computation of the present value of the charitable lead interest for purposes of the income, estate, and gift tax deduction is done in the same manner as for charitable remainder trusts. Therefore, under §7520, the valuation of the annuity or unitrust interest, and the remainder interest, must be computed by using the valuation tables published by the Internal Revenue Service with an assumed interest rate equal to 120% of the §1274(d)(1) mid-term rate for the month in which the trust is funded, compounded annually, or such federal rate in either of the two previous months.

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[5] The charitable lead trust is assumed to generate income at the §7520 rate, which is generally a below-market rate of return.

[6] An elderly person with a short life expectancy can obtain the compounding benefits of financial leverage over a long period by creating a charitable lead trust for a fixed period that is expected to continue long after the person dies.

[7] *See* §170(f)(2)(B) for the federal income tax charitable deduction, §2055(e)(2)(B) for the federal estate tax charitable deduction, and §2522(c)(2)(B) for the federal charitable gift tax deduction and the regulations thereunder.

[8] That fixed sum is not dependent upon the trust's income.

[9] A person can create a charitable lead trust for a fixed term that can continue after the person dies.

[10] See §664(d)(1)(A) for charitable remainder annuity trusts and §664(d)(2)(A) for charitable remainder unitrusts, and the regulations thereunder.

[11] §664(d)(1)(A), §664(d)(2)(A).

[12] *See* Rev. Rul. 1977-374, 1977-2 C.B. 329.

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A qualifying charitable lead trust in either of the above forms may be structured for income tax purposes as a grantor trust or a non-grantor trust. A grantor CLAT allows the creator of the trust to deduct for income tax purposes, in the year of the trust's creation, as a charitable contribution, the present value of the charitable lead interest on the date of the gift to the trust. However, as a trade-off for this immediate income tax deduction, the creator of the grantor trust must report each year the trust's income during the term of the trust, thus effectively offsetting the benefit of the initial income tax charitable deduction.

A non-grantor CLAT is classified as a complex trust for income tax purposes and thus treated as a separate taxpayer for federal income tax purposes. Therefore, each year the trust must file its own income tax return, will report its income, and each year the CLAT is entitled to its own charitable income tax deduction for each year's annual charitable payment. Because the CLAT is not an individual, it can offset 100% of its taxable income with its charitable deduction.[13]

ILLUSTRATION OF THE BENEFITS OF ASSIGNING INCOME TO A CLAT

Assume Fred establishes a non-grantor CLAT with a fixed term of 22 years and, at the end of the term, any balance remaining will be distributed to Fred's son.[14] Fred transfers $200,000 of his income-producing assets into this trust. The terms of the trust require the trustee pay $10,000 annually[15] to Fred's favorite charitable organizations. Fred will no longer make charitable gifts from his personal account. He will accomplish his charitable giving through his charitable lead trust. More importantly, Fred's gross income will no longer include the income generated from the $200,000 of income-producing investments contributed to the CLAT.

As a result of Fred establishing a CLAT, his gross income will be $200,000 rather than $210,000.[16] Under the 2017 tax act, Fred will still get the benefit of the $12,000 standard deduction, and his taxable income will be $188,000 (gross income of $200,000 less the standard deduction). His annual tax liability will therefore be approximately $41,850 (rather than $45,050 if no CLAT is established). Fred will therefore save approximately $3,200 in income taxes every year the trust is in existence.[17] If Fred was in a 37% income tax bracket, the assignment of $10,000 of income will save $3,700 each year.

If the remainder interest is not zeroed out, Fred will be making a taxable gift at the time he creates the CLAT provided he did not retain any control over the trust assets to cause the gift to be incomplete.[18] One should consider using a fixed term designed to zero-out the value of the remainder interest passing to Fred's son. If there is a value for the remainder interest, Fred will use his applicable exemption when he files his federal gift tax return. If the income-producing assets in the charitable lead trust continues to generate a rate of return greater than the §7520 rate, the trust will have a balance at the termination of the trust. By designing the zeroed-out CLAT with a fixed term so that the annual annuity equals the actual income generated by the $200,000 of trust principal, all $200,000 of trust principal will pass to his son without any gift tax or estate tax.

Although the CLAT will file a separate income tax return, it will not pay any income tax. The non-grantor CLAT will be able to take a charitable deduction for the entire distribution to Fred's favorite charitable organizations.[19] As a result, Fred will have successfully assigned $10,000 of his income every year to another taxpayer with no tax being paid on such assigned income. The separate taxpayer (i.e., the CLAT) will provide Fred with his desired annual charitable

[13] This unlimited charitable deduction may be taken pursuant to §642(c)(1). The deduction for individuals making charitable contributions is limited to a specified percentage of the individual's adjusted gross income for the taxable year, disregarding any net operating loss carryback to the year under §172. *See* §170(b)(1)(G). The 2017 tax act increases such income-based percentage limitation by an individual taxpayer of cash to public charities and certain other organizations from 50% to 60%. Unlike an individual, the charitable lead trust cannot carry over its unused charitable deduction. No provision is made in §642(c)(1) or related regulations for a carryover by fiduciaries.

[14] The planner should be aware that §2642(e) provides that the inclusion ratio for generation-skipping transfer (GST) tax purposes may not be computed until the termination of the charitable interest. Thus, GST tax issues may arise if the remainder interest passes to a skip person. One approach to plan for this issue is to give a child of the grantor a general power of appointment. The increase of the GST tax exemption as a result of the 2017 tax act may help eliminate this issue for many taxpayers but care still must to taken since the increased GST tax exemption under the 2017 tax act sunsets on January 1, 2026.

[15] The amount necessary to zero out the CLAT has no relationship to the standard deduction. The trust agreement will have the amount of the payment set forth by way of a formula so as to equal the percentage of the initial net fair market value of the trust as shall produce a guaranteed charitable annuity interest and gift tax charitable deduction equal to (or nearly as possible) in value to 100% of the net fair market value of the entire trust fund upon its creation.

[16] In prior years Fred received $10,000 of income from the $200,000 in his brokerage account.

[17] If Fred dies during the non-grantor CLAT term, the trust continues reporting its income and charitable deduction. Because Fred did not report an income tax charitable deduction, there is no recapture, and the assignment of income to the CLAT continues to benefit Fred's beneficiaries.

[18] The February 2018 §7520 rate is 2.8%.

[19] Such deduction may be taken pursuant to §642(c)(1).

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giving but in a way that also reduces his individual income tax. He essentially gets the benefit of the itemized charitable deduction by removing his source of income that provided the funds to make the annual charitable gift in the first place.

In prior years, Fred received $10,000 of income from the $200,000 in his brokerage account, but that income was offset by his itemized deduction. The 2017 tax act took away his charitable deduction but left his income exposed to taxation. The above technique provides a way for Fred to continue his annual charitable gifts as he has always done, but removes from his gross income the income that provided the funds to make the gift. Fred also still gets the benefit of the increased standard deduction.

Note that it is necessary for Fred to create a non-grantor CLAT to accomplish his objectives. A grantor CLAT, like any other grantor trust, is not a separate taxpaying entity. As noted above, while a grantor, in the year of creating the grantor CLAT, may deduct for income tax purposes as a charitable contribution the amount of the present value of the charitable annuity interest on the date of the gift to the trust, he or she must also report on his or her individual income tax return the trust's income for each year during the term of the trust. Consequently, a grantor CLAT cannot be used if assignment of income is one of the tax objectives of creating the CLAT.

Married spouses filing a joint individual tax return may also benefit from assigning income to a non-grantor CLAT. The standard deduction for married individuals filing a joint return increased to $24,000. Thus, it is likely many married individuals will no longer itemize their deductions, but will continue to make charitable gifts. A CLAT should be considered as a possible solution to continue to make such gifts in a tax-efficient manner.

COMPARISON OF A POSSIBLE ALTERNATIVE APPROACH

Taxpayers faced with the loss of the tax benefit of their charitable contributions may establish a donor-advised fund through a community foundation to continue their annual charitable giving. Such a gift may also achieve an assignment of income because a taxpayer funds the donor-advised fund with income-producing assets thereby removing from his or her gross income the income produced by such assets.

A community foundation is a tax-exempt public charitable organization with the objective of establishing permanent funds from public donations to provide support for various charitable initiatives of the residents in a given area. Each fund has its own defined purpose or field of interest, but the foundation's board of directors decides the charitable organizations that will be the recipients of the annual charitable gifts. A donor may retain the right to recommend to the community foundation the charity to receive the annual payments but has no legal right to direct or control such decisions. Donor-advised funds are a popular charitable technique due to the relative ease of creating them while offering individuals a way to make a gift that receives the same tax deduction they would receive for any other gift to a public charity.

Donor-advised funds will be a preferred vehicle to use for those individuals who wish to establish a permanent charitable fund. However, charitable lead trusts will be preferred for those individuals who wish to establish a fund to provide annual charitable gifts for a defined period of time while keeping the balance of the fund to benefit his or her descendants.

CONCLUSION

The 2017 tax act made significant changes to the Code. One of those changes appears to take away the ability for some taxpayers to continue to deduct charitable contributions. However, a CLAT provides such taxpayers with the tax benefit of the lost charitable deduction while taking advantage of the increased standard deduction. A CLAT allows a taxpayer to assign the income used to make charitable gifts to a trust who will then make the charitable gifts instead of the taxpayer. The trust will deduct the charitable contribution in full and thereby not pay income tax on the trust income used for the charitable payments. The taxpayer will therefore continue to provide funds to his or her favorite charitable organizations. In addition, the taxpayer will have less income to report and therefore pay less income tax.

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