The Unusual Taxation of Charitable Trusts and Annuities

Take-Away: Many individuals, especially those in advance of a large liquidity event, establish charitable remainder unitrusts (CRUTs.) Later, those same individuals, for a variety of reasons, may want to change the terms of their CRUT, either to terminate the CRUT or to shift from the CRUT to a charitable gift annuity (CGA.) These changes, if made, will trigger some unexpected tax consequences that need to be fully understood.

Practical Example: Barb, age 66, funds a CRUT in 2019 with appreciated stock. The stock has a fair market value of $1.0 million. Barb's church is named as the CRUT's remainder beneficiary. Barb's CRUT's terms will pay her 5% of the CRUT's asset each year; this payout rate selected by Barb was made to optimize Barb's up-front income tax charitable deduction when the CRUT is funded. The stock in the CRUT is sold over the following 5 years. After 5 years the CRUT's assets are now worth $1.75 million. Barb is now 71 years old, and, for a variety of reasons, she now wants to have a fixed stream of income in her retirement years. Barb cannot, mid-stream, change the CRUT's 5% payout rate. [Regulation 1.664-2(a)93)(ii).] Barb can, however, exchange her unitrust interest for a charitable gift annuity (CGA) issued by her church. [PLR 200152018.] There will be several tax consequences for Barb to consider if the exchange occurs, which Barb will have to consider when she negotiates the CGA's payment terms with her church.

CRUT Exchange: Barb will first need to know the base amount of what is being exchanged. It will not be the total value of the CRUT's assets. Instead, it is the present value of Barb's unitrust payments under the CRUT that will be exchanged by her. It will be necessary to compare the CGA's payments to Barb unitrust payments. If the CRUT's assets are worth $1.75 million when the proposed exchange is to occur, Barb's annual CRUT payment will be $87,500, and the present value of Barb's aggregate unitrust payments will be roughly $850,000. The American Council on Gift Annuities uses a 6.4% annuity rate for a 71-year-old individual. If that rate is applied as part of the exchange, then Barb's annual, fixed, CGA payment will be $54,382, or $33,118 less than if Barb had continued with the CRUT. Barb can claim an unlimited charitable gift tax deduction for her implied gift on the exchange. [IRC 2522(a).]

CRUT Termination: Using the same example, assume that Barb and her church reach an agreement to terminate the CRUT. The termination results in a division of the CRUT's assets between Barb and her church. This distribution of assets to Barb will not be treated as a distribution from the CRUT to her, which would otherwise be subject to the tiered accounting rules for charitable trusts. [IRC 664.] Rather, Barb will be treated as if she has **zero basis in the distributed assets** to her. [IRC 1001(e)(1).] Barb's gain recognition is the excess of the amount she realized (the present value of her surrendered unitrust payments) in the sale or exchange, less her adjusted basis, which is zero ($0.00.) In short, IRC 1001(e) will treat Barb as having no basis in her portion of the CRUT's property, and IRC 1001(c) will cause Barb to **realize the entire amount as taxable capital gains** from the disposition of her CRUT interest.

Capital Gains: The basis of Barb's income interest in the CRUT is $0.00. Thus, none of the CRUT payments to Barb over her projected lifetime will be a tax-free return of principal. However, the income interest that Barb surrenders in exchange for her CGA payments is a capital asset. [Revenue Ruling 72-243.] This capital asset is not excluded from capital gains treatment. [IRC 1221(a)(1)-(8).] Because Barb has had an income interest in the CRUT since 2019, she is thus surrendering a long-term capital asset. During her lifetime Barb's CGA payments will be a combination of ordinary income and capital gains.

Conclusion: The income tax consequences of a CRUT are more than just the tiered taxation regime under IRC 644. The exchange or termination of a CRUT has other unusual tax consequences that must be factored into the decision to exchange or terminate the CRUT.

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