

## Non-grantor Trusts and Charitable Giving

**Take-Away:** Adding a charity as a discretionary beneficiary of trust income is a simple advance planning strategy that can be used to minimize the trust's exposure to high, confiscatory, federal income tax brackets.

**Background:** An irrevocable trust is subject to the 35% federal income tax bracket when its accumulated income exceeds \$11,457 in 2025, and its income is taxed at the highest marginal 37% bracket when the trust's income exceeds \$15,650. These compressed income tax brackets are something to be avoided, if possible.

**Charitable Income Tax Deductions:** A non-grantor trust is entitled to a charitable income tax deduction, but the deduction for a trust differs considerably from the charitable income tax deduction available to an individual. As a generalization, (i) the charity must be a named beneficiary of the trust, and (ii) the contribution to the charity must come from the trust's income. However, unlike individuals who are limited in their charitable deduction by the amount of their adjusted gross income (AGI), a trust's allowable charitable income tax deduction is not subject to adjusted gross income limits. Yet the trust's charitable deduction may have more deduction carryforward limits, as those carryforward deductions are restricted from offsetting certain types of income.

**Deduction Conditions:** For a non-grantor trust to deduct charitable contributions, specific provisions must be included in the trust instrument. IRC 642(c)(1) allows a qualifying IRC 170(c) charitable organization to receive trust distributions (usually discretionary). However, to become tax deductible by the trust, the distribution to the charity must come solely from trust income- that restriction must be 'hard-wired' into the trust instrument, it cannot be satisfied by the trustee limiting its discretion to make distributions from trust income. Consequently, based on this requirement, a *simple trust* [as defined in the Tax Code] will not qualify for a charitable donation/deduction since *all* trust income is required to be distributed to the trust's non-charitable beneficiary. [PLR 8446007, July 31, 1984.]

**Bracket Compression:** The good news though is that if this Tax Code requirement is met, the trust may receive a charitable income tax deduction usually with no income limitations which can help to keep the trust from the gravitating into the federal marginal 35%- or 37%-

income tax brackets. This is always important when you remember that a non-grantor trust will be subject to these highly compressed federal income tax brackets. Thus, the opportunity for the trustee to distribute from trust income to a charity makes sense, depending first, as always, on the needs of the non-charitable trust beneficiaries. Distributions to donor advised funds opened by the family would be a logical charity to receive the trust's income to manage the trust's accumulated income's tax exposure.

**Deduction Carryforward Limits:** A couple of exceptions exist where a trust is subject to a percentage income deduction limitation. These limitations are when a trust is treated (i) as a taxable private foundation and as (ii) an electing small business trust (ESBTs) where there is an S corporation portion of income generated by the trust. [IRC 642(c)(6), 641(c)(2)(E)(ii).]

**Restrictions:** There are two additional restrictions on a trust's charitable income tax deduction which are that the trust may not offset (i) unrelated business income, or (ii) any *qualified* small business stock gain exclusion. [IRC 681(a), 642(c)(4).] As a result, many trusts may not carry over any unused charitable deductions, so that charitable deductions are available to offset income would be unnecessary if that is a priority (exceptions for specific nonexempt charitable and split-interest trusts.) [Regulation 1.642(c)-4.]

**Drawbacks:** While including a charity as a potential discretionary beneficiary of trust income may make sense from an income tax-savings perspective, it is important to remember that the charity's participation and consent will be required if there is ever a need to modify the terms of the non-grantor trust in a probate court proceeding, or notice must be given to the charity if the trustee ever decides to decant trust assets to a new trust. In addition, the Michigan Attorney General-Charitable Trust Division will have a stake in protecting the charity's interests in the trust, along with the trustee's special annual reporting obligations to the Attorney General since it will be classified as a 'charitable trust.'

**Conclusion:** If a *dynasty*-type of non-grantor trust is contemplated by a family, including the trustee's ability to either accumulate income or to spray income among a large group of potential trust beneficiaries, adding a charity, or charities, as potential beneficiaries of trust income may make sense, both to avoid the higher compressed income tax brackets to which the trust is subject, and to fulfill the settlor, or the individual trust beneficiaries' philanthropic objectives, e.g., funding a donor advised fund. It may be possible to name the

trust beneficiaries as the trust's distribution directors, restricted to charitable distributions of trust income to discrete charities, thus giving those beneficiaries a limited voice in which charity or charities that they wish to benefit. Including charities as discretionary beneficiaries of trust income can be part of a long-term strategy to make a non-grantor trust more flexible to meet the settlor's philanthropy, while minimizing exposure to the current confiscatory federal income tax brackets.

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