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Insight | November 2020

Improving the Tax Management of Charitable Remainder Unitrusts

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As the COVID-19 pandemic and its economic burden persist, charitable organizations need additional support to meet many critical needs in our communities, particularly during the holiday season. Now may be a perfect time for taxable investors to think about making their donations through charitable remainder trusts (CRTs). This vehicle provides an income tax deduction for a portion of the donated value, as well as reducing the donor's estate for tax purposes. It also allows the donor to avoid immediate recognition of capital gains taxes on donated appreciated assets.

Charitable remainder trusts come in two forms: the charitable remainder unitrust (CRUT) and the charitable remainder annuity trust (CRAT). However, an Internal Revenue Service (IRS) rule makes CRUTs better suited in a low-interest-rate environment to achieve the dual purposes of a CRT: financial security for the donor's family and support for their chosen charity. This paper discusses how the tax management capabilities of a Parametric Custom Core® separately managed account can help serve both purposes.

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Overview

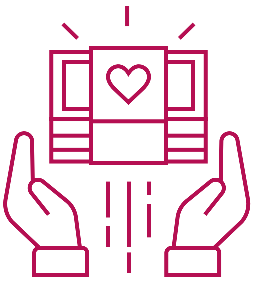
The unitrust feature guarantees a remainder for the charity.

The key difference between the two forms of CRTs is that a CRUT pays to the donor or their designated beneficiaries a percentage of the annual valuation of the trust, while a CRAT pays a percentage of the initial contribution valuation, which then becomes an annuity. Both types of trusts have required payout rates of no less than 5% or more than 50%. Once the term of the trust has passed, the remainder of the principal goes to one or more charities.

In both forms of a CRT, the value of the gift to charity—the charitable remainder interest—is measured using an actuarial calculation that takes into account both the term of years of the trust and the IRS Section 7520 rate. This rate is published monthly by the government and considers the prevailing market rate of interest. Generally speaking, the longer the term of the trust and/or the lower the Section 7520 rate, the lower the present value of the remainder interest.

For a CRT to qualify as a CRAT, the present value of the charitable remainder interest must not be less than 10% of the initial fair market value of the property contributed to the trust. If there's an actuarial probability of 5% or greater that the charity won't receive the required 10% interest, the IRS requires the income tax deduction to be denied. Current low Section 7520 rates have made this test problematic for CRATs. However, CRUTs are unaffected by the 5% test because the unitrust feature guarantees a remainder for the charity.

CRUTs illustrated



Let's assume the donor has an estate valued at $5 million. They hope to achieve two goals: to make a donation to charity, and to receive an income stream each year from their assets. To satisfy both objectives, they decide to gift $1 million of appreciated assets to a CRUT. The term is for 20 years with an initial payout of $50,000.

Based on these assumptions, when the IRS discount rate is 0.04%—as it is in November 2020—the donor will receive an income tax deduction of approximately $350,000. In addition to this initial deduction, they'll receive $50,000 in income for the first year. Future income received will be determined each year based on the trust's value. At the trust's completion, the remaining trust assets will move out of the donor's estate, and the charity of their choice will receive the remainder.

The upfront income tax deduction for the donor is the present value of the charity's remainder interest. For gifts of capital gains property, the income tax deduction taken in any one year can't exceed 30% of adjusted gross income (AGI). Due to the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act, the deduction can't exceed 100% of AGI for cash gifts. If the income tax deduction in any one year exceeds the AGI limits, the income tax deduction may be carried forward for a maximum of five years.

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How CRUT income is taxed

A CRUT itself is generally exempt from tax, just as other charities are. However, unitrust distributions are subject to tax. The IRS uses characterization rules to determine the nature of distributions from the trust. These rules presume the income most likely to yield tax to beneficiary is distributed first. Dividends and other ordinary income realized within the trust are distributed prior to long-term capital gains.

The character of distributions received by CRT income beneficiaries is determined using a separate-tier system, which establishes an order for the distribution of four categories of income and corpus. Any distribution received by a beneficiary is deemed to have come from the first category to the extent of current-year or accumulated income in this category. When all current and accumulated income in the first category has been exhausted, the ordering proceeds to the second category of income, and so on.

Four categories of CRT income

Tier 1

Distributions are first taxed as ordinary income to the extent of the trust's ordinary income for the current year plus its undistributed ordinary income from prior years.

Tier 2

Distributions in excess of the ordinary income tier are taxed to the beneficiary as capital gains to the extent of the CRT's current or accumulated capital gains. The trust's long-term gains and losses are combined, as are its short-term gains and losses.

Tier 3

Distributions in excess of the first two income tiers are taxed as other income exempt from tax to the extent of current or accumulated tax-exempt income.

Tier 4

Any remaining distributions are treated as made from principal.

Source: Internal Revenue Code Section 664. For informational purposes only.

Managing CRUTs' tax impact with Parametric Custom Core®

Parametric Custom Core SMAs seek to provide investors more control over capital gain and loss realization while seeking equity-market-like returns. This control can help mitigate the impact of the tiered CRUT distribution rules and provide flexibility to respond to potentially rising tax rates.

Using the sample case above, let's assume the donor sells the contributed appreciated assets and makes a cash investment in a Custom Core large-cap equity portfolio worth $500,000. The portfolio seeks to provide the pretax return of a benchmark like the S&P 500® while systematically harvesting tax losses. The donor can use these excess losses to shelter gains realized by the CRUT's other investments.

Short-term losses get netted against short-term gains and can reduce the early distribution of these more highly taxed gains on the donor's income tax return. Both short-term and long-term unused excess losses are carried forward for use in a future year's distribution determination. If there are no net short-term gains, the more favorably taxed long-term gains would be deemed distributed, with the nontaxable income and principal to follow.

If other CRUT investments are expected to produce net short-term gains, the Custom Core account can sustain the opportunity for short-term loss realization by employing strategic gains realization. This approach intentionally realizes long-term capital gains to reset the holding period. This can provide a meaningful tax rate arbitrage where the investor pays a 23.8% tax on long-term capital gains to potentially avoid paying a 40.8% tax on short-term capital gains. This approach can also improve the portfolio's tracking error and refresh its cost basis, which can enable future loss harvesting. If tax rates go up in 2021, systematic loss harvesting will be even more valuable.

CRTs are often mistakenly considered a way to unlock the embedded gains in an appreciated asset and receive a tax-exempt income stream in return. The idea is to have the donor contribute an appreciated asset to a CRT, at which point the trust sells the asset and reinvests the proceeds in tax-exempt securities. However, under the tiered system of income allocation, the income stream received by the beneficiary will be deemed capital gain income due to the accumulated gain on the sale of the appreciated asset. Only when this gain is exhausted will the beneficiary receive tax-exempt income. This means the income beneficiary will have to report the entire gain before recognizing any tax-exempt income.

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The systematic loss harvesting benefits of Custom Core can help reduce net gains to the donor while pursuing market-like returns, both for themselves and for their chosen charity.

Conclusion

Investors looking for ways to benefit their favorite causes while protecting their family's finances should consider investing in a CRT. Controlling the realization of capital gains and losses is a useful approach in managing the tax on CRT distributions. Whether the donor keeps their assets inside or outside a CRT, the systematic loss-harvesting benefits of Custom Core can help reduce net gains to the donor while pursuing market-like returns, both for themselves and for their chosen charity.

This article is for general educational purposes only and is not intended as legal or tax advice.

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Bob is responsible for distribution channel management for the HNW/Retail, International, and DCIO Institutional segments. Bob also leads Parametric's Family Office Advisory Group, a family office resource. Prior to joining Parametric in 1998, Bob was a vice president with Harris Bank and a manager in the family wealth and financial planning practice of Arthur Andersen & Co. He earned a BA in economics from Wabash College and a JD from Valparaiso University.

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About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is a wholly owned subsidiary of Eaton Vance Corp. and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York City, and Westport, Connecticut.

Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies or to request a copy of Parametric's Form ADV, please contact us at 206 694 5575 or visit www.parametricportfolio.com.

36848 | 11.11.2020