

## Charitable Strategies for Trust Beneficiaries

**This *Trust Topics* presents the benefits of making distributions of appreciated property for philanthropically-minded beneficiaries.**

Certain trusts permit distributions to be made to trust beneficiaries at the discretion of the trustee. There are benefits to making these distributions in the form of appreciated property—also called a distribution in kind. A distribution in kind is a distribution of property (for example, shares of stock), rather than cash, from a trust. The technique of distributing appreciated property bears investigating for the potential advantages to trust beneficiaries and charitable organizations that receive gifts from trust distributions.

When a trustee distributes appreciated property to a beneficiary, the trustee can determine the capital gains treatment of the distribution. The trustee does this in accordance with an election granted under Section 643(e)(3) of the Internal Revenue Code, commonly referred to as the 643(e) election.

### **Trustee may elect to recognize a capital gain**

A trustee may elect to treat a distribution in kind as if the distributed property had been sold to the beneficiary at its fair market value on the distribution date. If that election is made, a capital gain is generated equal to the difference between the adjusted cost basis of the property and the fair market value of the property. (Adjusted cost basis is the original value of an asset adjusted for, among other things, mergers, stock splits and reinvested dividends.) That capital gain is taxable at the trust level. The beneficiary's cost basis in the property will be the fair market value of the property distributed. Such an election would not typically be made unless the trust had offsetting losses.

### **Trustee may decide not to recognize a capital gain**

If a trustee distributes appreciated property and does not elect to recognize a capital gain, no gain is recognized by the trust. The beneficiary's cost basis in the property remains the adjusted cost basis of the trustee (not the fair market value). The beneficiary would, therefore, realize a capital gain upon the sale of the assets.

If, instead of selling the property and recognizing a capital gain, the beneficiary contributes the appreciated property to charity, everyone may benefit. Scenarios One and Two outline this strategy.

### **Scenario one: When the trustee has the discretion to distribute both income and principal**

Consider a trust in which the trustee has the discretion to pay income and principal to the beneficiary. Assume the trust has received dividend and interest income of \$50,000 for the year. The trustee decides to distribute securities from the principal of the trust (a distribution in kind) and not the dividend and interest income.

For example, assume the trustee chooses to distribute ABC stock purchased in 1970 that now has a fair market value of \$50,000 and an adjusted cost basis of \$10,000. The stock distribution is made to a trust beneficiary.

The trustee in this scenario does not elect to recognize a capital gain, which means that the trustee's adjusted cost basis is passed on to the beneficiary. In other words, no gain is recognized on the distribution to the beneficiary; it is capital gains tax neutral.

The beneficiary, in turn, chooses to contribute the distributed property to a charitable organization.

### **Scenario one: Win-win tax result**

- The amount of ordinary income the beneficiary has to report is limited to \$10,000. That is, the ordinary income reportable by the beneficiary is only the value of the adjusted cost basis of the securities, not the \$50,000 fair market value of the securities;
- Further, the beneficiary is able to claim a charitable income tax deduction of \$50,000 when the charitable gift is made (subject to certain limitations based on the beneficiary's overall income); and
- No capital gain is recognized by either the beneficiary or the trust. In addition, the charitable organization can sell the securities at any time without incurring capital gains taxes. Thus, no capital gains taxes need to be paid by any of the three parties: trust, beneficiary or charity.

As is the case with individuals, trusts are responsible for paying taxes on dividend and interest income earned during the year. However, to the extent a distribution is made to a trust beneficiary, the trust is entitled to a distribution deduction to offset income.

In this scenario, the trust is entitled to a deduction equal to the value of the adjusted cost basis of the securities distributed. Thus, the trust would potentially be liable for taxes on only \$40,000 of dividend and interest income (the \$50,000

of dividend and interest income earned by the trust, less the \$10,000 distribution deduction).

The trust must still pay taxes on \$40,000 of income earned for the year, but the trustee has the benefit of being able to reinvest the net income after taxes in any manner the trustee likes. If all the income was distributed to the beneficiaries, the trustee might be forced to sell some existing trust holdings to raise the cash to make a new investment. And that sale might have capital gains tax consequences of its own.

The trustee has, in effect, diversified a low basis stock position without incurring any capital gains taxes. In accordance with the Prudent Investor Rule, which is the law governing the investment of trust assets in most states, a trustee must diversify trust assets, unless the trustee determines that it is in the interest of the beneficiary not to diversify. Accordingly, for trusts with a large block of low-basis stock, the strategy bears consideration as part of a tax-efficient diversification program.

In addition, the beneficiary has made a contribution of appreciated securities to a charitable organization without generating any capital gains for a charitable deduction equal to the *fair market value* of the securities.

### **Scenario two: When the trustee is required to distribute income and has the discretion to distribute principal**

Consider use of this strategy for a trust that requires all of its income to be paid to the beneficiary, and the trustee, in the trustee's discretion, can make principal payments to the beneficiary.

Assume the trust has dividend and interest income of \$50,000 for the year, and the trustee is required to distribute that \$50,000 to the beneficiary. In addition, as a principal distribution, the trustee chooses to distribute securities with a fair market value of \$50,000 and an adjusted cost basis of \$10,000 to the beneficiary. The trustee does not elect to recognize a capital gain. The beneficiary contributes the distributed property to a charitable organization.

### **Scenario two: Win-win tax result**

- The amount of ordinary income the beneficiary has to report is limited to \$50,000 (the amount of the dividend and interest income distributed). The distribution of the securities with a fair market value of \$50,000 is in effect a tax-free distribution of principal (assuming any capital gains taxes payable as a result of the sale of other trust assets during the course of the year are paid by the trust);

- Further, the beneficiary can claim a charitable income tax deduction of \$50,000 when the charitable gift is made (subject to certain limitations based on the beneficiary's overall income); and
- No capital gain is recognized by either the beneficiary or the trust, and the charity can sell the securities without the imposition of capital gains taxes. Again, no capital gains taxes need to be paid by any of the three parties: trust, beneficiary or charity.

From the trustee's standpoint, since the trust is required to distribute all of its income, no income tax is payable by the trust on that income, and no capital gain is recognized on the principal distribution.

### **Trustee's discretion is key**

For philanthropically-minded trust beneficiaries, the benefits of distributing appreciated property in kind for all involved can be very attractive. However, for the strategy to work in either scenario, a distribution in kind must be made at the trustee's *discretion* from either income or principal. A distribution in kind would not result in the same benefits if, for example, the distribution to the beneficiary is made in satisfaction of an obligation to distribute a fixed amount. In that case, a capital gain will be recognized at the trust level, and a capital gains tax will be payable by the trustee. The trustee would not be able to distribute low-basis securities to the beneficiary without capital gains tax consequences.

If the trustee has discretion, the technique of distributing appreciated property in kind is well worth exploring.

About the authors:

**Sharon L. Klein**, Senior Vice President, Trust Counsel and Director of Estate Advisement, has over 17 years' experience in the area of trusts and estates and is a frequent speaker and author on estate and trust planning, administration and management issues. Prior to joining Fiduciary Trust, Ms. Klein was Special Counsel in the trusts and estates department at Rosenman & Colin LLP (now Katten Muchin Rosenman). Previously, she served as law clerk to the Hon. Chief Judge Fox of the Federal Court of Australia. Ms. Klein received B.A. and LL.B. degrees from the University of New South Wales, Sydney, Australia, and an LL.M. from the Boalt Hall School of Law at the University

of California, Berkeley.

**Henry S. Ziegler, Esq.** is a graduate of Harvard College and Columbia Law School. He was formerly a senior vice president and special advisor for global estate planning at Fiduciary Trust Company International. In addition he was a partner of Shearman & Sterling, where he headed up the individual clients practice group, which represented clients in trust and estate, tax and related matters. In addition, Mr. Ziegler was chairman and CEO of Deutsche Bank Trust Company.

