

Charitable Remainder Trusts

A charitable remainder trust is a vehicle that allows an individual to provide an income stream to himself and other individuals for lifetime or a specified term at a reduced transfer tax cost, while also satisfying the donor's charitable intentions.

CHARITABLE REMAINDER TRUSTS

1. In General. A charitable remainder trust (CRT), as defined in Section 664 of the Internal Revenue Code (the "Code"), may be created either during a donor's lifetime or at a donor's death and must provide for the distribution of a specified payment at least annually to one or more non-charitable persons. Individuals, trusts, estates, partnerships, and corporations are eligible to receive the annual distributions. If the recipients of these payments are individuals, the payment period must either be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or be for a term of years not to exceed 20 years. Upon the termination of these non-charitable interests, all of the assets remaining in the trust must either be transferred irrevocably to or for the use of a qualifying charitable organization approved by the Internal Revenue Service ("IRS") or retained in further trust for a qualifying charitable use. Because the economic benefits of a CRT are "split" or divided between charitable and non-charitable beneficiaries, such trusts are also commonly referred to as "split interest charitable trusts." As discussed below, such trusts are subject to very strict organizational and operational rules and tests in order to qualify as CRTs under federal tax law.

There are two types of charitable remainder trusts—a charitable remainder annuity trust and a charitable remainder unitrust. A charitable remainder annuity trust (CRAT) is required to annually pay a sum certain to one or more non-charitable beneficiaries. The "sum certain" must be equal to at least 5%, but no more than 50%, of the fair market value of the trust assets, valued only as of the date the assets are transferred to the trust. For example, if one were to transfer \$1,000,000 of stock to a CRAT, the trust would have to make an annuity payment or payments totaling at least \$50,000 ($\$1,000,000 \times .05$) per year. The payment from the CRAT would remain constant during the term of the trust.

A charitable remainder unitrust (CRUT) is required to annually pay a fixed percentage of its fair market value to one or more non-charitable beneficiaries. The fixed percentage must be equal to at least 5%, but no more than 50%, of the fair market value of the trust assets determined on an annual valuation date. Thus, the amount paid by a CRUT fluctuates with the fair market value of the trust's assets. In addition, a CRUT may provide for payment of the lesser of the fixed percentage or the amount of income actually generated by the trust, in which case it is known as a "net income" unitrust (NICRUT). A NICRUT may (but need not) provide that any amount by which the trust income falls short of the fixed percentage is to be paid out in subsequent years to the extent that the trust's income exceeds the fixed percentage in later years. If it contains such a make-up provision, the trust is referred to as a "net income make-up" unitrust (a NIMCRUT).

Another significant difference between a CRUT and a CRAT is that no additional contributions can be made to a CRAT after the initial funding, whereas additional contributions can be made to a CRUT.

2. Other Specific Requirements. A CRT is a fairly inflexible vehicle. In order to qualify as a CRT, the trust instrument must be irrevocable and it must create a valid trust under local law. Significant changes generally cannot be made to a CRT after it is created. For example, the trust would not qualify as a CRT if anyone had the power to invade the trust principal or alter, amend, or revoke any provision of the trust for the benefit of any person other than the charitable beneficiary. These restrictions would be most burdensome if the donor established the trust during his or her lifetime and wished to retain certain powers over the trust.

As for investing trust assets, the trustee must be able to invest such assets in a manner that produces a reasonable return. Therefore, a provision that restricts the trustee only to a certain type of investment (for example, tax-exempt bonds) disqualifies the trust. No payments other than the annuity amount or unitrust amount can be made from a CRT (this includes payments to the IRS). However, this restriction does not prohibit a transfer in

exchange for full and adequate consideration. In other words, a CRT can purchase and sell assets.

During its term, a CRT is subject to many of the same rules that apply to a private foundation. Those rules impose excise taxes on self-dealing transactions, excess business holdings, investments jeopardizing the trust's charitable purposes, and expenditures for non-charitable purposes (such as lobbying or influencing legislation).

Finally, upon the termination of the non-charitable income interests, the remaining principal must be transferred outright to or for the use of one or more charitable organizations described in Section 170(c) of the Code, which governs the income tax charitable deduction.

3. Tax Consequences Upon Creation.

A. Estate and Gift Tax Charitable Deduction.

The estate and gift tax effect of a CRT is most easily viewed by dividing the trust into the non-charitable portion (the annuity or unitrust interest) and the charitable portion (the remainder interest). As stated above, the non-charitable beneficiaries of a CRT can be the donor or one or more third parties. If the non-charitable beneficiary is the donor or the donor's spouse, there are no taxable gifts arising from the creation of the trust because the donor cannot make a gift to himself or herself, and the spouse's interest is eligible for the marital deduction from gift or estate tax, depending on whether the CRT was created during lifetime or at death. If the non-charitable beneficiary is a person other than the donor or the donor's spouse, the transfer to the trust gives rise to a taxable gift to the extent of the non-charitable portion. Regardless of whom the non-charitable beneficiary is, the charitable portion of a CRT is fully deductible for gift tax purposes if given to a qualified charity. In the case of a CRT created upon the donor's death for a non-charitable beneficiary other than the donor's spouse, the value of the assets passing to the CRT will be included in the donor's estate for estate tax purposes, but the donor's estate is entitled to a charitable deduction to the extent of the charitable portion. In order to determine the impact of the charitable deduction on the donor's transfer tax liability, the value of the charitable portion must be computed.

(i) The Value of the Gift to Charity. For a CRAT, the value of the charitable portion is the net fair market value of the property placed in trust, less the present value of the annual annuity payments. The

present value of the annuity payments is determined by using interest rates and actuarial tables issued by the IRS based on the life expectancies of the beneficiaries or the term of years of the trust.

Calculating the value of the remainder interest in a CRUT is more complex. It is determined by computing an "adjusted payout rate" and applying the appropriate actuarial tables.

For illustration purposes, assume that a donor establishes a CRT for the benefit of the donor's daughter, age 50, and funds it with property having a fair market value of \$1 million, at a time when the relevant IRS interest rate is 7%. (The Treasury Department publishes these interest rates on a monthly basis.) Under these circumstances, the value of the remainder gift to charity (and, therefore, the charitable deduction available to the donor), under varying assumptions for both an annuity trust and a unitrust, are as follows:

<u>Payout % (and Amount)</u>	<u>Value of Gift to Annuity Trust</u>	<u>Charity Unitrust</u>
5% (= \$50,000/yr)	\$ 416,315	\$ 259,430
6% (= \$60,000/yr)	\$ 299,578	\$ 205,980
7% (= \$70,000/yr)	\$ 182,841	\$ 165,860

Using the numbers above, if the donor established a CRAT for the donor's daughter with a 5% payout (assuming one payment per year), then each year \$50,000 would be paid to the donor's daughter for the remainder of the daughter's lifetime, after which the remaining trust assets would be distributed to charity. Upon creation, the donor would have made a taxable gift of \$583,685 (\$1 million less a charitable deduction of \$416,315). If the donor established a unitrust, the initial yearly payment would be \$50,000, but that annual payment would fluctuate each succeeding year as the value of the trust assets fluctuated. The taxable gift would be \$740,570 (\$1 million less a charitable deduction of \$259,430). On the other hand, if the non-charitable beneficiary were the donor or the donor's spouse (rather than the donor's daughter), no taxable gift would occur because the donor cannot make a taxable gift to himself, and the spouse's interest is eligible for the unlimited gift tax marital deduction.

The chart above illustrates that the charitable deduction increases as the payout percentage decreases. Intuitively, this makes sense because the trust will be paying out less to the non-charitable beneficiary over the term and, therefore, more will remain in the trust for the charity. You can also see

from the chart that a donor generally receives a lower charitable deduction when establishing a CRUT.

(ii) **The Ten Percent Remainder Rule.** The value of the charity's remainder interest in the CRT must equal:

(a) for a CRAT, at least 10% of the initial fair market value, or

(b) for a CRUT, at least 10% of the value of the property being contributed as of the date of contribution.

Thus, if \$1,000,000 is used to fund a CRAT or is being contributed to a CRUT, the value of the remainder interest, as calculated using the appropriate IRS tables, must equal at least \$100,000.

(iii) **The Five Percent Exhaustion Rule.** Similarly, a charitable deduction may not be available if the statistical probability that the charitable remainder beneficiary will not receive any trust principal exceeds 5%. Thus, a CRT must be structured so that the principal of the trust is not depleted during the term of the trust.

To avoid this 5% rule, the annuity payments or unitrust payments should not be set too high, particularly when the non-charitable beneficiary's life expectancy is fairly long. Because the payout of a CRUT is always a percentage of the fair market value of the trusts assets valued each year, the charity will always receive trust principal. Thus, although it is possible for CRUTs to be subject to the 5% rule, the unitrust rate must be very high and the non-charitable beneficiary's life expectancy must be long. And of course, if the CRUT is structured as a NICRUT (a net income unitrust), the 5% rule does not apply because the unitrust payment is the lesser of the trust's annual income or the unitrust amount. As a result, the principal of the trust will never be depleted.

B. Income Taxation Deduction for Donor. If the CRT is funded during the donor's lifetime, the charity's remainder interest in the charitable remainder trust is eligible for the income tax charitable deduction and is calculated using the same rules described in the example above. Of course, the income tax deduction is subject to the normal limits on charitable contributions, but any amount not deductible in the year of contribution may generally be carried forward for up to five years.

C. Income Taxation of the Recipient of the Annuity or Unitrust Amount. The tax character of the annuity or unitrust payments that the non-charitable beneficiaries receive is determined under the so-called "tier rules" set forth in Section 664(b) of the Code. For this purpose, these rules supersede all other provisions of the Code. CRTs themselves are generally exempt from income tax (unless the trust borrows money to purchase investments, operates a business, holds mortgaged property, or receives unrelated business taxable income); therefore, the income of the CRT is generally taxed only to the extent of the annuity or unitrust payments and only when those payments are actually made to the non-charitable beneficiary.

Under the income tax tier rules, annuity or unitrust payments are deemed to consist first of ordinary income to the extent of the trust's ordinary income (for example, interest income) for the taxable year of the distribution and the trust's ordinary income from prior years not deemed to have been previously distributed. An ordinary loss, which is any loss from the sale or exchange of property that is not a capital asset, offsets ordinary income. Deductions that are directly attributable to the ordinary income earned by the trust reduce the trust's ordinary income. In addition, any deductions not directly attributable to one of the tiers is allocated pro rata among all tiers. If the annuity or unitrust payments in a particular year exceed the trust's current year ordinary income and all prior undistributed ordinary income, the excess payment is next deemed to be composed of capital gain income to the extent of the trust's capital gain income (that is, the proceeds from the sale of securities and other capital gain property) for the current year and the undistributed capital gains from earlier years. If highly appreciated property were sold, for example, the trust could have a substantial amount of undistributed capital gains.

After the income of the capital gain tier is exhausted, excess annuity or unitrust payments are next deemed to come from "other income" to the extent of the trust's "other income" for the current year and its undistributed "other income" for prior years. The income tax impact on the recipient of the annuity or unitrust amount of "other income" depends on the nature of the "other income." For example, "other income" includes proceeds of life insurance, gifts and inheritances, and tax-exempt bond income. Since none of these receipts are taxable, deemed payments from these sources do not constitute taxable income to the recipient.

When the current and undistributed income and capital gain of the above three tier categories are exhausted, annuity or unitrust payments are deemed to be made from trust principal. These distributions do not have any tax impact.

The determination of the character of the annuity or unitrust payments is made as of the end of the trust's taxable year. If there is more than one annuity or unitrust recipient, each recipient is treated as receiving a pro rata share from each category.

4. Conclusion.

A CRT can have different structures depending on the donor's purposes in establishing it. Establishing a charitable remainder trust can be an effective way to provide a donor's estate with a charitable deduction and other non-charitable beneficiaries with an income stream for their lives. On the other hand, a charitable remainder trust could also be a useful tool for a donor to convert a highly appreciated capital asset into an income stream during his or her lifetime while avoiding or deferring the taxation of capital gain on the sale of the asset.