15. THE CHARITABLE REMAINDER TRUST

The Charitable Remainder Trust

Common Trust Characteristics

While the charitable remainder trust (CRT) is a unique, highly sophisticated, and flexible charitable gift-planning tool, it shares common features with other types of trusts. Regardless of type, each trust has a creator, "the one who trusts." Terms such as "grantor," "trustor," or "settlor" refer to the one who establishes the trust. In the case of the CRT, the grantor is also properly termed "the donor." The second common feature is the trustee, "the one who is trusted." The trustee cares for the trust assets on behalf of the trustor/donor and beneficiary in accordance with the instructions contained in the trust document and applicable state and federal law.

A third common characteristic is the "trust" itself. At its essence, a trust is a relationship between the trustor and trustee. The trustor-trustee relationship is commonly described by a written legal document called "the trust." The trust document expresses the basic understanding between the trustor and trustee. It instructs the trustee and expresses the trustor's intent. Such a document is essential to the CRT because of the need to satisfy Internal Revenue Code requirements in order to secure the CRT benefits to the donor and charity. The CRT is not only an expression of a relationship, but it is also a legal entity, like a person or corporation, having its own rights and responsibilities. As a legal entity, the CRT upon application is assigned its own taxpayer identification number by the IRS.

A fourth common trust characteristic is property. "Assets" are the things held in trust. The CRT donor irrevocably transfers asset ownership to the trustee. Assets may be held in the form in which they are received or sold and reinvested. Assets are so fundamental to the CRT that it must "own" assets (be funded) in order to exist.

Common to all trusts are the rights to use and enjoy the benefits of the trust assets. The CRT has one or more beneficiaries (at least one of which must be a non-charitable beneficiary) entitled to receive trust payments, as well as a qualified charitable organization entitled to receive assets at the trust's termination (the remainder beneficiary).

Split Interest Trust

The CRT provides a way to blend philanthropic intent with financial benefits for the donor or another income beneficiary. Because of these two distinct elements, a CRT is a *split-interest* trust; that is to say, one interest to a non-charitable entity (e.g. donor or family) and a second interest to a qualified charity. In this respect a CRT is similar to charitable gift annuity, charitable lead trust, pooled life income agreement, and life estate reserved gift plans.

Charitable Remainder Trust Models

The CRT is defined and the qualifying requirements are spelled out in Internal Revenue Code (IRC) Section 664, related regulations, Revenue Rulings and Revenue Procedures. The IRC provides five different models or forms which differ only in respect to how the amount payable to the income beneficiary is determined. The IRC and related regulations begin with the simplest form of payment calculation format and progress to the most complex.

Annuity Trust

The basic model is that of an annuity trust (charitable remainder annuity trust or CRAT) which pays a fixed annuity payment to the income beneficiary. The annuity amount may be expressed as a fixed dollar amount or as a fixed percentage of the net fair market value (FMV) of the trust assets at the time they are placed into trust. Regardless of how it is expressed, the annuity amount must be at least 5% and not more than 50% of the net FMV of trust assets as of the date of transfer. Once established, the annuity amount never changes. Additional contributions to an annuity trust are not allowed. The annuity amount is paid to the income beneficiary whether or not it is earned. In those years when the annuity amount is greater than the trust income, principal is invaded in order to provide the full payment. Consequently, over time the trust principal can decline to the point of total depletion. A CRAT measured by the life expectancy of the income beneficiary must have a 5% or lower probability that trust assets will be exhausted before the charity receives the remainder interest. The 5% probability test does not apply to a term of years CRAT. If trust principal is exhausted, payments to the income beneficiary stop and the trust terminates. Because of the rigidity of the required annuity payment, only liquid or readily marketable assets such as cash and publicly traded securities are suitable for funding a CRAT.

Standard Unitrust

The next most complex form, the unitrust (charitable remainder unitrust or CRUT), pays a fixed percentage of at least 5% and not more than 50% of the net FMV of trust assets as *valued annually*. The trust document typically designates the first business day of the year as the valuation date. Thus the feature added to the basic model is that of a *variable* net FMV of trust assets upon which the unitrust payment is based. This type of CRUT is commonly called a straight or standard unitrust (StanCRUT or SCRUT). In years when the stated unitrust amount payable to the income beneficiary is greater than trust income, trust principal is invaded to pay the full unitrust amount. Depending on investment performance, the annual trust value may increase or decrease, thus the actual amount payable correspondingly increases or decreases. Even though it is possible for the trust principal to decline, because the payment amount is based on a variable principal value the probability of exhausting the principal is negligible. Consequently the unitrust is not subject to the 5% probability test.

Net Income Unitrust

In order to relieve the trustee of the obligation to distribute principal in years when net trust income is less than the stated unitrust payment, the IRC allows for two income exception

variations of the unitrust. The first income exception trust pays the *lesser* of net trust income or a fixed percentage which is at least 5% and not more than 50% of the net fair market value of trust assets as valued annually. This income exception model is commonly called a net income unitrust or simply NICRUT. Trust principal is not invaded. Generally, depending on state law and the trust document (see IRC §643(b) and applicable regulations), the definition of“income” is limited to interest, dividend, rents, and royalties. Therefore, capital appreciation is generally not paid to the income beneficiary, but is added to principal. Under the NICRUT, the income beneficiary never receives more than the stated fixed percentage, but may receive less than that amount.

Net Income with Make-up Unitrust

The second exception, the net income with makeup option (NIMCRUT), may pay the income beneficiary an amount in excess of the required unitrust amount. As in the NICRUT (net income only CRUT), the income beneficiary receives the *lesser* of the trust's net income or a fixed percentage which is at least 5% and not more than 50% of the net FMV of trust assets as valued annually. However, in a year when the net trust income is less than the unitrust payout amount, the difference between the net income and the fixed unitrust percentage is designated as a deficit amount. In any year when the trust earns more than the unitrust percentage the excess can be used to *make up* any amount not paid in previous years when the trust earned less than the unitrust amount. When the aggregate deficit from previous years is fully paid, then any excess income is added to principal. Any excess income added to principal cannot be recovered to pay any subsequent deficit.

FLIP Unitrust

In addition to the two income exception options above, the IRC provides for a final option which was designed to effectively manage what the code calls “unmarketable” assets until such time as they are sold and reinvested for capital growth as well as income. This option, the so-called FLIP unitrust, begins as either a net income (NICRUT) or net income with make-up (NIMCRUT) agreement. At the occurrence of a “triggering event,” the payment calculation method converts (or flips) to a standard unitrust (StanCRUT) method. The unitrust document must expressly allow for the conversion/flip and define the “triggering event.” Examples include: a future calendar date, marriage, divorce, death, or the sale of the “unmarketable” trust assets. Once the trust is executed, the donor cannot have direct control over the triggering event. The actual conversion/flip occurs on January 1 of the year following the triggering event. Because the StanCRUT does not allow for any deficit or make up, any deficit amount related to the NIMCRUT is forfeited.

Administrative Concerns

Qualification as a Charitable Remainder Trust

In order for a trust to qualify as a CRT it must meet all of the requirements of the Internal Revenue Code (IRC) §664, its related regulations, Revenue Rulings and Revenue Procedures. Not only must the trust document contain the proper provisions, but the trustee must manage the

trust as a charitable remainder trust. The trust must either be an annuity trust or unitrust from its inception. No blending of the two payout forms is permitted. Annuity or unitrust payments to income beneficiaries must actually be made. The income beneficiaries may be one or more persons, at least one of which is not a charity as described in IRC §170(c). Neither the grantor nor any other person may be considered owner of the trust under the Grantor Trust rules (IRC§§671-678).

In addition, the present value of the remainder interest (the amount available as an income tax charitable deduction) must be at least 10% of the FMV of assets initially transferred to the trust. As indicated above, the stated payout to the income beneficiary must be at least 5% and no more than 50% of the FMV of trust assets as of the date of transfer. A CRAT must also have less than a 5% probability of totally depleting its assets. The charitable remainder must be payable to an organization described in IRC§170(c).

Tax Exempt Status

A qualified charitable remainder trust is tax exempt. Accordingly, it pays no tax on realized gain when selling appreciated assets or on trust income and the donor is eligible for income, gift and estate tax charitable deductions.

This extremely important feature enables the trustee to convert highly appreciated assets into a current income stream without erosion due to the donor paying capital gains tax when selling and reinvesting the cash. Increased cash flow to the donor results from transferring assets and their related management expense from their personal estate to the trust. The trustee is able to sell trust assets at no tax cost and reallocate assets for better diversification, thus improving risk management. Unless the donor also serves as trustee, asset management and investment responsibilities are shifted to another party. At maturity when the trust measuring term expires, trust assets pass to the designated charitable beneficiary without probate.

The Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006, included a provision affecting the taxation of any charitable remainder trust (CRT) that has any unrelated business taxable income (UBTI). Under the old law, if a CRT had any UBTI, the entire CRT would lose its tax exempt status for any and every year it had UBTI. That could result in catastrophic consequences for some CRTs with lots of income that would otherwise have been tax-exempt.

Under the new law, effective for taxable years beginning after December 31, 2006, a CRT that has UBTI will no longer lose its tax-exempt status for the year and will no longer be subject to any income tax. Instead, an excise tax will be imposed that is equal to the entire amount of the UBTI. This new provision should be good news for most CRTs. However, it could produce disastrous results in some situations.

Tax Returns

Even though the CRT is tax exempt, the Trustee must file annually:

- Form 5227, *Split Interest Trust Information Return*
- Form K-1 which describes the character of trust distributions
- State tax and information returns where required.

An Employer (taxpayer) Identification Number (EIN) should be obtained from the IRS at the inception of the CRT. A copy of the CRT Agreement is filed with the initial Form 5227.

Measuring Term

The obligation to pay the income beneficiary begins at the creation of the charitable remainder trust, when it is executed and funded. The period of time during which the trustee pays the unitrust or annuity amount to the income beneficiary is called the *measuring term* of the trust. This period is irrevocably designated in the trust document. The measuring term is most commonly expressed as a term of years (not to exceed 20), the life of an individual income beneficiary, or the lives of multiple beneficiaries.

Early Termination

A CRT is an irrevocable trust. However, it may be terminated before the conclusion of the measuring period. To accomplish this, the income beneficiary must surrender or donate to the charitable remainder beneficiary all rights to future unitrust or annuity amounts. This donation yields an income tax charitable deduction for the present value of the donated income interest. Consequently, the charitable remainder beneficiary "owns" all interests in the trust (income and remainder). The trustee will terminate the trust and distribute all remaining assets to the charitable remainderman for its exempt purposes.

Potential Trustees

Subject to local law, a CRT trustee may be an individual, bank, trust company, charitable remainder beneficiary (if permitted by its constitution and by-laws), or other professional trust administrator. In some circumstances, the donor/grantor might elect to serve as trustee. Caution must be taken to avoid the trust being designated a grantor trust for income tax purposes because the donor-trustee retains too much control over the trust. This decision should be made only in after careful consideration of the technical aspects and need for specialized assistance. Occasionally, a special independent trustee should be appointed to care for certain transactions such as valuing and selling real estate or other hard to value assets. A donor-trustee would be well advised to retain competent tax, legal, and investment professionals to assist in trust administration.

<u>Private Foundation Rules</u>

A charitable remainder trust is subject to private foundation rules and applicable excise taxes against acts of self-dealing. Such acts include, but are not limited to, loans, sales, leases, providing goods or services between a charitable remainder trust and a disqualified person, or such transactions between the trustee and a disqualified person. Disqualified persons include the trustee, the creator of the trust (trustor/donor), anyone who contributes more than $5,000.00 to the trust, the spouse, ancestors, children, grandchildren, great grandchildren and the spouses of all such persons. Other disqualified persons also exist. Consult competent legal counsel. Examples of forbidden acts of self dealing may include the trustor continuing to use a trust asset (living in a dwelling after transferring it to the trust) or the trustee paying trust or trustor expenses with its own funds.

<u>Knowledgeable Legal Counsel</u>

Creation of charitable gift plans, such as the charitable remainder trust, requires the participation of competent legal counsel knowledgeable in this area of the law. Not only should the denominational entity be served by counsel, but perhaps more importantly, the donor should receive independent legal counsel and tax advice. Good practice and prudence dictates that denominational entities advise the donor in writing of the need for such independent professional advisors.

<u>Unauthorized Practice of Law</u>

While Planned Giving & Trust Services personnel serving in their gift planning capacity may discuss and illustrate the various features of a particular gift plan, prohibitions against the unauthorized practice of law preclude anyone other than competent legal counsel from rendering legal advice and/or drafting legal documents. Independent professional advisors help protect the donor's interest and shelter the denominational entity from accusations of undue influence, conflict of interest, and the unauthorized practice of law. These protections will reduce the risk of potential legal challenges to charitable gift plans and preserve the donor's intent to support the various ministries of the Church.

Funding the CRT and Reporting the Gift

<u>Suitable Assets</u>

While some assets are problematic, such as debt encumbered property, sole proprietorships, professional practices, and assets with no ready market, a wide variety of assets are suitable to fund a CRT. These include cash, cash equivalents, publicly traded securities, closely held stock in C corporations, and certain real estate. Gifts of highly appreciated assets take advantage of the CRT tax exempt status to avoid capital gain on the transfer to trust, sale within the trust without tax cost, and reallocation of asset investment for growth, income, and risk management.

Cautions

Care must be taken to insure that the CRT avoids all unrelated business taxable income (UBTI) and issues involving self-dealing when accepting assets. Certain savings bonds can be transferred to a CRT. However, the donor may be taxed on all accrued income when the bonds are transferred. While real estate can be an excellent CRT asset, there are numerous factors to be considered, such as: the potential presence of hazardous waste, marketability, property taxes, insurance, ability to produce income, UBTI, valuation, title concerns, pre-sale expenses, etc.

Valuing the Gift

Donations of cash and publicly listed securities have readily ascertainable values. Transfers of non-cash assets (except publicly traded securities) where the deductible value is greater than $5,000 ($10,000 if closely held stock) require a qualified appraisal performed by a qualified appraiser (as defined by the Internal Revenue Code and Regulations) and the completion of appropriate sections of IRS Form 8283. The appraisal may be conducted any time within 60 days prior to the asset's transfer to the trust and the due date (including extensions) of the tax return in which the charitable deduction is claimed. A copy of the appraisal as well as Form 8283 and the Trust document must accompany the donor's tax return for the year of the transfer. Donations of similar assets to multiple donees are combined for purposes of the $5,000 threshold test ($10,000 for closely held stock).

Gift Substantiation

Because the charitable remainder beneficiary designation is often revocable and in some instances there may be no charity specifically designated, charitable remainder trusts are exempt from the requirement to provide the donor with a written gift substantiation under IRC §170(f)(8) (Hoffman, pp. 192, 193). The donor will file the appraisal summary (Form 8283) and the trustee will acknowledge receipt of assets in the Donee Acknowledgement section of the 8283. A copy of the gift illustration showing how the deductible amount was determined should be provided to the donor.

Tax Implications

Income Tax

Charitable Deduction and Limitation

Generally, a charitable deduction is only available for transfers of present interests. However, the IRC allows an income tax charitable deduction for the present value of the future charitable interest for donations to qualified charitable remainder trusts. The present value of the remainder interest must be at least 10% of the fair market value of assets on the transfer date. If the CRT remainder beneficiary is a public charity, such as a church or school, the deduction is limited to 50% of the donor's adjusted gross income (AGI) for gifts of cash, short-term capital-gains property and other ordinary income property. Gifts of long-term appreciated property such as

real estate and securities are limited to 30% of AGI. Contributions that exceed these limitations may be carried over for an additional five years. The donor may elect to reduce the value of long term capital property to its basis rather than fair market value for purposes of valuing the asset for the charitable deduction. This election permits such donations to be subject to the 50% limitation, thus avoiding the more restrictive 30% limitation. This step-down election must apply to all contributions of long term capital gains property made in the election year.

Tax Consequence to Income Beneficiary

Unitrust and annuity trust payments to the income beneficiary are taxable to the beneficiary according to a four-tier ordering system. The so called “four-tier system” distributes, to the extent it is earned by the trust that year and undistributed from prior years, first, ordinary income, then capital gains, tax exempt income, and finally tax free return of principal. The general rule is that within each “tier” or category the income class subject to the highest (or worst) tax rate is distributed first (WIFO: worst in, first out). Accordingly, within the “ordinary income” tier (category), interest and ordinary dividends, which are taxed at the recipient’s highest rate, are distributed first. Then qualified dividends, which are taxed at a lower rate, are distributed. Once the trust exhausts the ordinary income category, it then distributes the income class within the capital gain category that is taxed at the highest rate. Within the capital gain tier short term capital gain, which is taxed as high as 35%, is distributed first, then long term capital gain is distributed. Since different types of long term gain are taxed at different rates, long term gain is distributed in order from highest to the lowest rates. If a CRT does not distribute all of its income in a particular class, that income is carried forward indefinitely within its class for possible distribution in a future year. The trustee reports the type of income distributed to the beneficiary on Form K-1.

Read distribution order from left to right:							
1.Ordinary Income Tier		**2. Capital Gain Tier**				**3. Other Income Tier**	**4. Principal Tier**
Interest & ordinary dividends	Qualified dividends	Short Term	Long Term			Tax Exempt	**Basis**
			Collectibles	Depreciation Recapture on Real Estate	Other LTG		
*35%	15%	35%*	28%	25%	15%**	0%	**0%**

*Varies depending on Recipient’s Tax rate (10% - 35%)
**0% if Recipient is in 10% or 15% brackets

The spread between the various tax rates is significant. The type of income earned by various trust investments determines the net after tax benefit to the income beneficiary. The prudent investor standard dictates that trust investments yield the most “tax efficient” result for the income beneficiary.

Gift Tax

Lifetime Gifts

There is a potential “gift tax” on lifetime transfers made for less than adequate consideration (gratuitous transfers). In the CRT, when the donor names another person as income beneficiary

there are essentially two gifts: the remainder to charity and the income to the other person. This may produce gift tax consequences. The gift of the remainder interest to charity receives the benefit of the unlimited charitable deduction so no gift tax is incurred. The gift of the income interest to the donor's spouse (if a U.S. citizen), for a term of years or for life, qualifies for the unlimited marital deduction and there is no gift tax.

Gift to Non-spouse

An irrevocable gift of the income benefit to a non-spouse is a taxable gift for gift tax purposes. It is deemed a completed gift of the present value of the income interest in the year the trust is created and therefore qualifies for the annual gift tax exclusion ($13,000 per donee in 2011 and indexed for inflation) for that year. Any amount in excess of the exemption amount would count toward the unified gift and estate tax credit amount to the extent it is available.

Power to Revoke an Income Interest

If the donor reserves the right to revoke an income interest, the gift is not a completed present interest gift for gift tax purposes in the year the trust is created. As payments are received by the recipient, they become completed present interest taxable gifts and, as such, are subject to the $13,000 annual exclusion. Such a right to revoke must be expressed in the trust document and be exercisable only by the donor's will.

Reporting the Lifetime Gift

Even if no gift tax is due, the federal gift tax return, Form 709, should be filed by the donor for all CRT contributions, regardless of size, because he/she has made a split interest gift. The gift of a charitable remainder constitutes a gift of future interest for which the $13,000 annual exclusion is unavailable. Such a gift does qualify for an unlimited gift tax charitable deduction. The donor should obtain competent tax counsel from their own advisor in this matter.

Estate Tax

Transfers at Death

The Estate Tax is levied on the value of property possessed by a decedent at the time of death. In certain circumstances, the value of the income interest and/or trust value may be includible in the CRT donor's gross estate for estate tax purposes. In general, if the donor dies owning an income interest, or transfers an income interest at death to a non-spouse, then the value of that interest is includible in the gross estate for estate tax purposes. Estate tax consequences are dependent on several factors: who holds the income interest, if the donor retained the right to revoke the income interest in his/her will, whether the income interest expired before the donor's death, and the trust measuring term.

Term Certain CRT

If the donor is the income beneficiary of a fixed term CRT and dies before the expiration of the term, the full value of trust assets is includible in the donor's estate. The estate receives an estate tax charitable deduction for the present value of the charitable remainder as of the date of death, resulting in taxation on only the value of the remaining income interest (if any). If the spouse (if a U.S. citizen) is named the irrevocable income beneficiary of a fixed term CRT, there is no estate tax consequence to the donor. Likewise, if a non-spouse is named the income beneficiary, there is no estate tax on the value of the trust. The value of the taxable gift arising from the lifetime transfer of the income interest is added to the estate. However, it is offset by the amount of any gift tax previously paid.

One Life Measuring Term CRT

If the donor is the only income beneficiary of a one life measuring term CRT, the value of the trust assets are included in the estate for estate tax purposes. However, it is offset by an estate tax charitable tax deduction for the charitable remainder value. If the spouse (if a U.S. citizen) is the income beneficiary and the donor retains no rights to the trust, there is no estate tax consequence. If a non-spouse is the sole income beneficiary, there is no estate tax on the value of the trust. The value of the taxable gift arising from the lifetime transfer of the income interest is added to the estate. However, it is offset by the amount of any gift tax previously paid.

Multiple Lives Measuring Term

In two-life CRTs, the estate tax consequences depend on whether or not the donor has an interest in the trust which is sufficient to include its value in the gross estate. If the donor is an income beneficiary or retains the right to revoke the survivor beneficiary's income interest, the value of CRT assets is includible in the donor's estate. If the power to revoke is unexercised, the estate tax charitable deduction is limited to the present value of the charitable remainder as of the donor's date of death. If the power to revoke is exercised, then the trust terminates, assets pass to charity, and the estate receives a full charitable deduction for the value of the charitable remainder. If the sole surviving income beneficiary is the donor's spouse (if a U.S. citizen); then the estate is entitled to the "marital deduction for the value of the spouse's income interest." If the donor's spouse and another individual are the surviving income beneficiaries, there is no marital deduction available.

Gift and Estate Tax Summary

Donor Creates Lifetime Trust Paying Income to:	Taxable Gift?	Annual Gift Tax Exclusion?	Marital Deduction?	Included in Gross Estate?
1. Self for life	No	N/A	N/A	Yes, but 100% charitable deduction
2. Spouse for life	No	N/A	Yes	No
3. Self and spouse for life	No	N/A	Yes	Yes, but 100% marital deduction
4. Spouse and third person for life	Yes	Yes	No	No
5. Non-spouse for life, no right to revoke in will reserved	Yes	Yes	No	Yes, but charitable deduction for date of death remainder value
6. Self, then to non-spouse without right to revoke by will reserved	Yes	No (gift of future interest)	No	Yes, but charitable deduction for date of death remainder value
7. Self, then to non-spouse reserving right to revoke by will	No (gift incomplete)	N/A	No	Yes, but charitable deduction based on date of death remainder value
8. Self and non-spouse as joint and survivor beneficiaries, no right to revoke by will reserved	Yes	Yes	No	Yes, but charitable deduction based on age at donor's death
9. Non-spouse for life, reserving right to revoke by will	Probably as to annual payments, uncertain as to income interest	Yes, for annual payments	No	Yes, but charitable deduction based on age at donor's deat
10. on-spouse for term of years with right to revoke by will	Annual payments taxed	Yes, for annual payments	No	Yes, but charitable deduction based on remainder value at donor's death
11. Non-spouse for term of years, no right to revoke in will	Yes, on value of income interest	Yes	No	No-out of estate

Table taken from Charitable Giving Tax Service 7-110(c)
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Additional Resources

The foregoing discussion is not intended to be comprehensive, though it provides a brief review of certain features of the charitable remainder trust. For addition information, refer to the following:

Charitable Giving Tax Service, Volume 2, R & R Newkirk, Oak Brook, Illinois.

Marc D. Hoffman and Leland E. Hoffman, Jr. *Harnessing the Power of the Charitable Remainder Trust,* Eighth ed., Distributed by Philanthro Tec, Inc. Matthews, NC.

Moerschbaecher, Lynda S., *Plain English Planned Giving: After the Gift is Closed,* Published privately by the author as study material for seminars in planned giving.

Planned Giving Design Center. www.pgdcnet. Site contains extensive resource material on CRTs and other planned giving instruments. Marc Hoffman is editor.

Toce, Joseph P. et al, *Tax Economics of Charitable Giving*, Warren, Gorham, & Lamont of RIA.

Teitell, Conrad, *Substantiating Charitable Gifts,* Taxwise Giving, Old Greenwich, Connecticut