CHARITABLE REMAINDER TRUSTS

A Charitable Remainder Trust can provide significant benefits for the person who creates it while benefitting charity later. Although the IRS has recently put some additional restrictions on the trusts, the trusts still provide significant benefits in certain situations. The most advantageous situation is for an individual who has a highly appreciated asset and has a life expectancy of at least 20 years. But I'm getting ahead of myself. Let's look at the kinds of charitable remainder trusts, the flexibility we have in structuring them and their treatment from a tax perspective to give us a framework for assessing their benefits.

All charitable remainder trusts (CRTs) provide for payments to an individual during the term of the trust with the remainder passing to a charity upon the end of the term. The term of the CRT can be for the life of an individual or can be for a term of years not to exceed 20 years or a combination of both. If the life of an individual is combined with a term of years, the term must begin at the time the trust is created and may not begin at the time one of the individual life recipients dies.

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The individual who receives the payments during the term can be the grantor (the person who created the trust) or another person. If the individual is another person then the grantor will be considered have made a gift to the individual who is to receive the payments during the term of the trust. The amount of the gift to the individual will be the actuarial value of the payments to be received by the individual.

> The grantor receives a charitable income tax deduction at the time the trust is created for the actuarial value of the remainder which passes to charity.

Most trusts name the grantor or the grantor and his spouse as the recipient beneficiaries for the term of the trust. For simplicity I will assume that the grantor is also the recipient of the payments.

The grantor receives an income tax charitable deduction at the time the trust is created for the actuarial value of the remainder which passes to charity. The actuarial value of the amount passing to charity must be at least 10% of the value of the assets originally contributed to the trust. The charitable deduction is limited to 50% of the grantor's income if the remainder charity is a public charity and to 30% of the grantor's income if the remainder charity is (or can be) a private foundation. The grantor can retain the right to change the charity receiving the remainder interest of the trust.

The trust is a tax exempt entity. Therefore, if you transfer low basis

property to the trust and the property is sold, no tax will be owed by the trust. The payments made to the recipient during the term "carry out" the income in the trust over the life of the trust.

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For example, if the trust has $50,000 of income and the payment to the recipient is $50,000, the recipient will report all of the income as ordinary income. What if the trust did not have any income in the year of the payment? If the trust did not have any income in the year of the payment, the trust will be deemed to have distributed any income from prior years which was not distributed. For example, let's assume that in the first year of the trust, the trust had $60,000 in ordinary income and none in the second year. The trust had no other income. The first year the trust distributed $50,000 to the recipient and distributed another $50,000 to the recipient in the second year. The recipient would report $50,000 ordinary income in the first year and $10,000 ordinary income in the second year. In actuality, a non-taxable situation rarely occurs. Usually low basis property is transferred to the trust and is later sold with a large capital gain. After all ordinary income has been distributed to the recipient, the recipient will be deemed to have received capital gain until all the capital gains have been distributed.

Charitable Remainder Trusts come in two main types: charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). A charitable remainder annuity trust provides that the annual payment will be a fixed amount equal to a percentage of the value of the assets contributed to the trust. The percentage must be equal to or greater than 5%. For example, a charitable remainder annuity trust which is initially funded with $1 million and provides for a 5% annuity payment will pay $50,000 each year to the annuity recipient. The amount of the annuity (e.g. $50,000) will remain the same for the entire term of the trust.

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A charitable remainder unitrust provides that the annual payment will be a fixed percentage of the value of the assets held in the trust redetermined annually. For example, a charitable remainder trust which is initially funded with $1 million and provides for a 5% unitrust payment will pay $50,000 to the unitrust recipient in the first year. The amount paid to the unitrust recipient in the second year will depend on the value of the assets. Let's assume that the value of the trust assets have increased to $1,050,000. The unitrust payment in the second year will be $52,500. If the value of the trust assets have decreased to $950,000, then the unitrust payment in the second year will be $47,500. Which is better? If the value of the assets are likely to decline, then the annuity trust will pay more to the annuity recipient over the term of the trust. If the value of the assets are likely to increase, then the unitrust will pay more to the unitrust recipient over the term of the trust.

Our parameters in designing the trust are that the trust can be created for a term not to exceed 20 years or the life of a beneficiary, the payment may not be less than 5% per year, and the value of the remainder interest passing to charity cannot be less than 10% of the value of the remainder. Let's assume that you want to maximize the benefits that will be paid back to you. The value of the remainder depends on the current applicable federal rate. The higher the rate, the larger the remainder for an annuity trust but the applicable federal rate has very little impact on a unitrust. Let's look at some examples of the maximum payout you can have for a different trusts assuming an AFR of 7%:

Annuity Trust

Age of Recipient	(at 7% AFR) Maximum % payout	(at 9% AFR) Maximum % payout
30	6.78	8.46
40	7.14	8.77
50	7.32	9.17
60	7.67	9.42
70	8.34	9.97
20 year term	8.49	9.85

Unitrust

Age of Recipient	Maximum % payout**
30	5.52
40	7.18
50	10.21
60	16.01
70	27.05
20 year term	10.87

** A unitrust payout is not affected by the current applicable federal rate.

Ok, enough of this dry discussion - how do they really work and when would you want to use them? First, consider them when you have a charity that you would like to benefit on your death. If you would like to give a charity a certain asset, then you can transfer the asset to a trust, retaining a stream of annuity or unitrust payments for your lifetime with the charity receiving the asset upon your death. There are situations in which you will actually receive more money if you create a CRT than if you retained the property and held it outside of a trust. Your ears perk up. What are these situations?

If you have a zero basis or a very low basis in the property and you have a life expectancy of at least 20 years, then <u>you</u> will actually receive more money if you transfer the property to the CRT than if you retain the property.

In general, these situations are ones in which you have a zero basis or a very low basis in the property and you have a life expectancy of at least 20 years. If you are 60 years of age or younger you have a life expectancy of about 20 years. If you are married and you want to include your spouse as a beneficiary and have the trust continue until the last of you and your spouse to die, then you and your spouse have a combined life expectancy of at least 20 years if you are both 67 years of age or younger.

Let's assume a zero basis in the asset and compare the use of an 8% CRUT to selling the asset, paying the capital gains and investing the remaining funds at 12% (9.6% net assuming all

capital gains). We will assume that each annuity payment is received and reinvested at the same hypothetical 12% (9.6% after tax). The point at which the annuity recipient would have received more money having used the trust than if he did not is between 17-18 years. After the 17-18 year period you not only would have received more money than if you had not created any trust, but the charity of your choice will also receive a significant benefit. These benefits are even more significant to the individual when the charity is a private foundation. OK, let's say you like the idea. However, you want to ensure that you receive the benefits for at least the 17-18 years. You name your spouse but you want to provide that the trust will have a minimum term of 20 years, with your children as beneficiaries for the remainder of the 20-year term if both you and your spouse die. Sounds like a good plan, but there's a catch. Upon your death, the interest for your spouse will qualify for the marital deduction *only if* there are no other non-charitable beneficiaries. If both you and your spouse die within the 20 year period, there could be a significant tax upon your death if your spouse survives you. Let's use an example. Assume that you and your spouse are each 56 years old. You contribute $1 million to the trust and set the annuity at 8%. Your trust provides a return of 12% as you had hoped. The trust is paying out 8%, so the trust is increasing by 4% per year. At the end of 10 years, the trust has a value of $1.4 million. If you died in that year, the value of the interest to be received by your spouse would be $966,000. This interest would *not* qualify as a gift to your spouse if another person (in this case, your children) *could* receive the benefits from the trust. Therefore, the $966,000 would be taxable.

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Since you actually have more money than if the trust had not been created in 17-18 years, the disadvantage to your children occurs in the event of a premature death. To protect against this possible situation, it is much better to purchase insurance on the life of you and your spouse than to include your children as possible beneficiaries of the charitable remainder trust. The insurance should be owned by a trust to keep the insurance proceeds from being taxable in your estate.

The main benefits for the person creating the trust are the charitable income tax deduction and the tax exempt status of the trust. Of these two benefits, the tax exempt status of the trust is the more significant benefit. The charitable income tax deduction is limited to the value of the remainder interest. The charitable remainder interest is required to be at least 10% and is usually set at exactly 10%. The deduction for a $1 million gift would be $100,000 and assuming the donor is in the 35% bracket would save the donor $35,000. If the asset had a zero basis and was sold, the savings in capital gains tax on that sale alone would be $200,000. The accumulation of the gain inside the trust is tax free.

> You have some property that yields no income. You can create a NIMCRUT - a net income make-up charitable remainder unitrust.

Now let's assume that you have some property that yields no income. For example, let's assume that you have a piece of raw land or stock which does not pay a dividend. You do not want to force a sale of the asset in order to make the annual payments, nor do you want the trust to distribute part of the land or stock back to you in payment of the annual payment. Do you have another option? Yes, you can create a NIMCRUT - a net income make-up charitable remainder unitrust. This type of trust provides that you pay the *lesser of* the income in the trust or the unitrust payment. If there is no income in the trust then no unitrust payment is made. In years in which the income in the trust exceeds the amount of the unitrust payment, the trust can distribute the additional income to the extent that payments in the past were not made. Let's look at an example. Let's assume that you contributed $1 million commercial project to the trust. The project was not yet complete and thus did not yet yield any income. You create a 5% NIMCRUT. The trust owes you $50,000 in the first and second years but has no income in either year. In the third year the trust has $50,000 in income and in each year thereafter the trust has net income of $80,000. To keep the example from being too complicated, let's assume that the property held in the trust does not appreciate, so your unitrust payment continues to be $50,000 per year. In year three, the trust had $50,000 so it could pay the NIMCRUT payment. In year four the trust had $80,000 so it could pay the unitrust payment for that year of $50,000 plus $30,000 of the $100,000 payments which were not paid in years 1 and 2. Years five and six, the trust would also distribute $80,000 in payments. In year seven, the trust will pay out $60,000; the current year's payment of $50,000 plus $10,000 to make up the last of the $100,000 which was not paid in years 1 and 2.

> In addition, the capital gain attributable to the appreciation in the property after the trust was created *may* be capital gain, depending on the terms of the trust. The trust must provide that capital gain is considered trust accounting income.

Most of the time, the trust does not work this way. The trust is more likely to have stock or property worth $1 million which it sells, recognizes a large capital gain and then reinvests the proceeds from the sale. The capital gain attributable to the appreciation prior to the time the property is *not* and *cannot be* income for purposes of determining the income in the trust. In addition, the capital gain attributable to the appreciation in the property after the trust was created *may* be capital gain, depending on the terms of the trust. The trust must provide that capital gain is considered trust accounting income. In addition, in certain circumstances, a provision in the trust which allows the trustee to allocate capital gains to income or principal may allow capital gains to be considered income for purposes of determining income in the trust. Believe me, this is a trap for the unwary. I have seen several unitrusts over the years in which the individual recipients understood that capital gains income would be considered trust accounting income. In fact, in trusts which provide for large

unitrust payments, e.g. 10%, it is unlikely that these payments could ever be made without having capital gains be income. Keep in mind if the trust is a straight unitrust, not a NIMCRUT, it does not matter whether there is *any* income in the trust, so the existence of trust accounting income is only relevant in a NIMCRUT.

One method of distributing capital gain is to include a provision in the trust specifying that capital gains are income. Another method is to use a "FLIP" charitable trust. A FLIP is a NIMCRUT which flips to a straight unitrust upon the occurrence of an event. The impact of the NIMCRUT in actual practice should be carefully considered. NIMCRUTS should almost always provide that capital gains are income or provide that they flip to a straight unitrust upon the occurrence of a specified event.

As with most tax techniques, you should consider your overall objectives in light of the benefits and drawbacks of using a charitable remainder trust. In the right situation the charitable remainder trust can be very beneficial, even to the individual with little charitable interest.