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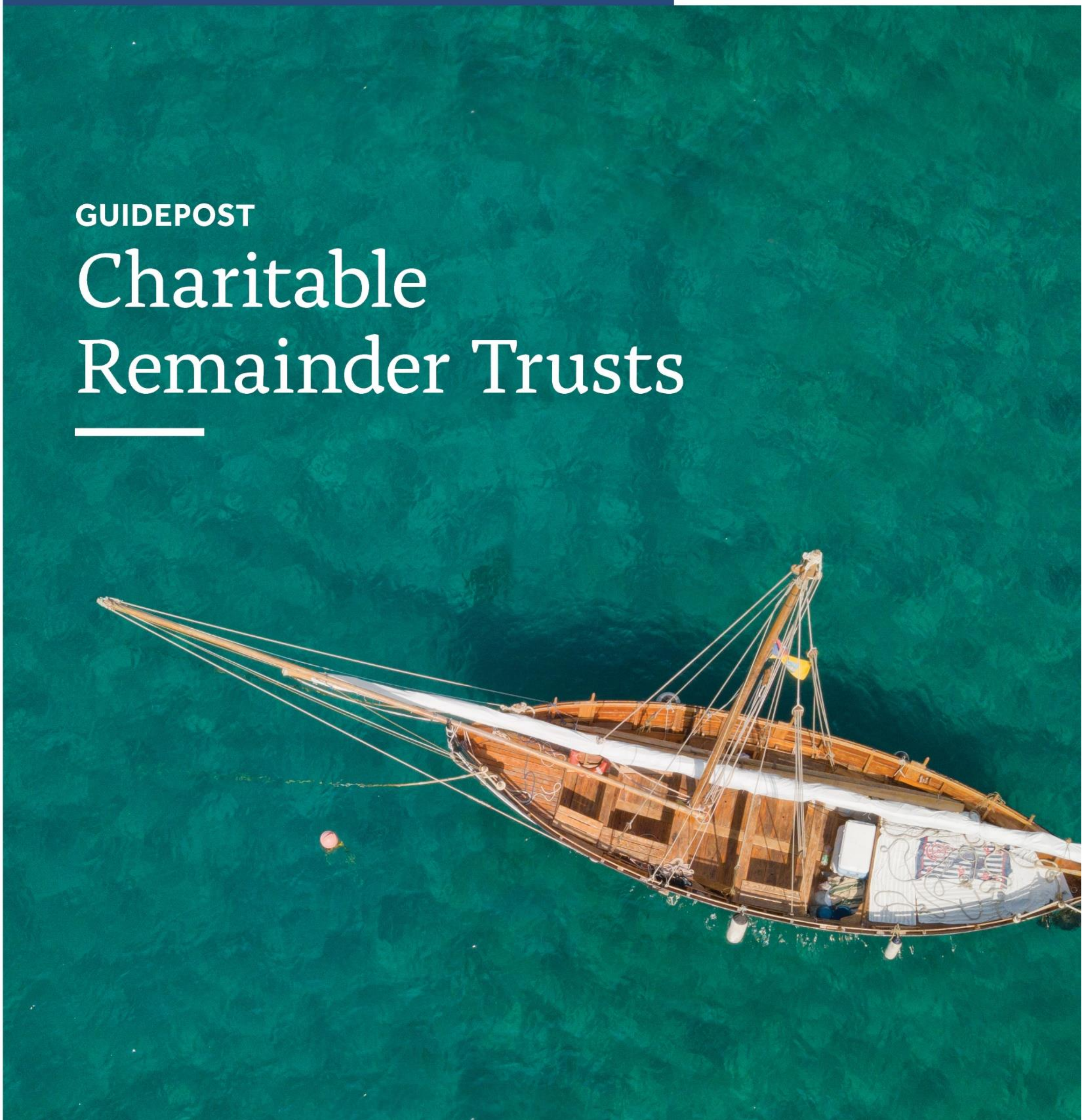
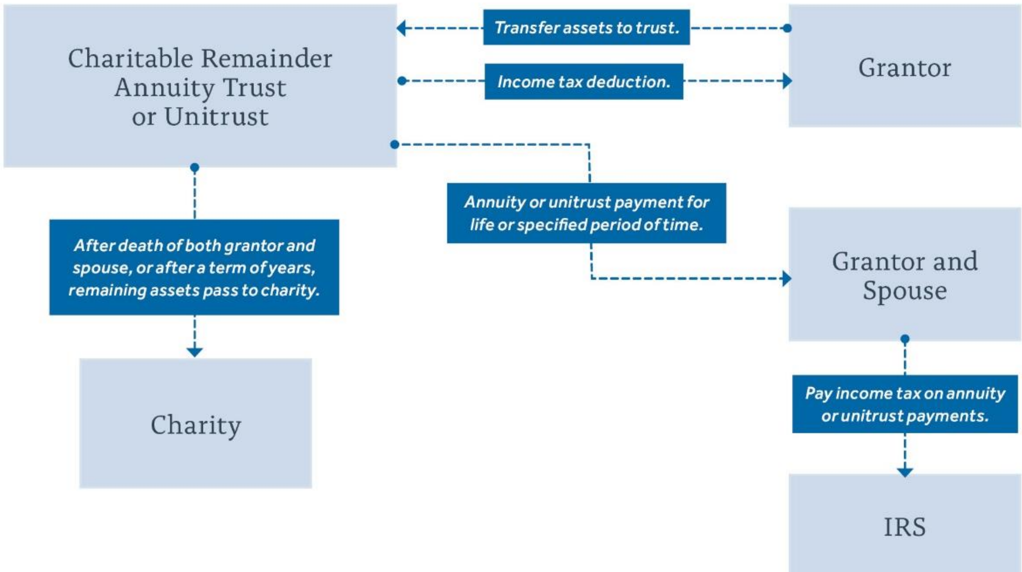


GUIDEPOST

Charitable Remainder Trusts

Charitable Remainder Trusts

A charitable remainder trust (CRT) allows a grantor to make a tax-deductible gift to charity while retaining an income interest for life, or for a term of years (not to exceed 20 years). At the end of the specified term, the remaining trust assets pass to a designated charity.



Description and Operation

The use of a CRT is generally appropriate when a grantor has the desire to:

- Increase income through the conversion of low yielding, highly appreciated assets;
- Generate an income tax charitable deduction and/or reduce potential estate tax exposure;
- Reduce or defer capital gains tax exposure;
- Spread the recognition of capital gain from the sale of an appreciated asset in order to help mitigate exposure to net investment income tax or to higher long-term capital gains and qualified dividends rates imposed on taxpayers with taxable income above specified levels; and/or
- Make a charitable gift that might not otherwise be possible.

Two primary types of CRTs exist: Charitable Remainder Annuity Trust (CRAT) and Charitable Remainder Unitrust (CRUT). Both types of CRTs must provide a payout to the non-charitable beneficiary at least once annually.

Charitable Remainder Annuity Trust (CRAT)

With a CRAT, the beneficiary receives a fixed annuity amount each year. The annuity amount can be either a fixed dollar amount or a percentage of the initial gift to the trust. The annual annuity payout cannot be less than 5% or exceed 50% of the initial value of the trust assets.

Also, the present value of the remainder interest passing to charity must be at least 10% of the fair market value of the property contributed as of the date of contribution. The latter requirement means that many CRATs established for the lifetime of a relatively young individual may not qualify. The problem is amplified if there is more than one lifetime beneficiary.

Once established, no additional contributions can be made to a CRAT.

Charitable Remainder Unitrust (CRUT)

With a CRUT, the beneficiary receives a percentage of the fair market value of the trust assets (the "unitrust amount") each year. The unitrust amount cannot be less than 5% nor exceed 50% of the net fair market value of the trust assets. The assets are revalued every year. Similar to the CRAT, the value of the remainder interest passing to charity must be at least 10% of the net fair market value of each contribution as of the date the property is contributed.

Additional contributions to a CRUT are permitted because a CRUT is subject to revaluation annually.

Tax Considerations

Income Tax – General

Generally, the CRT entity is exempt from income tax, unless the trust has unrelated business taxable income (UBTI). UBTI results when the trust has income from a trade or business owned by the charity, but not substantially related to its charitable purposes. UBTI also includes debt-financed income, such as income generated from mortgaged real estate. If a CRT has UBTI, the UBTI will be subject to a 100% excise tax.

Also, CRTs are subject to certain private foundation rules, which impose penalty taxes on prohibited trust activities. Certain nonexempt trusts that have charitable interests, as well as private interests, also may be subject to some of the tax provisions applicable to private foundations.

Income Tax – Grantor

A CRT grantor can generally take an income tax charitable deduction for the actuarial value of the charity’s remainder interest.

The **value of the charitable remainder** is computed based on three variables: (1) the statutory interest rate issued monthly by the U.S. Treasury Department pursuant to Internal Revenue Code (IRC) §7520 (referred to as the “Section 7520 rate”), (2) the duration of the income term (i.e., either a fixed term or the life expectancy of the income recipient), and (3) the annuity or unitrust income percentage rate.

- The grantor can select the Section 7520 rate for the month of the gift, or either of the two prior months. For CRATs, a higher interest rate significantly increases the value of the charitable remainder, thereby increasing the income tax deduction. For CRUTs, the Section 7520 rate has less effect on the charitable remainder because the amount paid to the income beneficiary is a percentage of the trust assets, as revalued each year.

In determining the **income tax charitable deduction**, both the nature of the contributed property and the nature of the charity are significant.

- Cash contributions may be deductible up to 60% of the contribution base if made to public charities and 30% of the contribution base if made to private foundations.
- Contributions of “ordinary income property,” regardless of the type of charity, are deductible based on the grantor’s cost basis. Ordinary income property is defined as property other than long-term capital gain property. Examples are business inventory, short-term capital gain property, and depreciated business property. The maximum deduction for contributions to public charities is 50% of the contribution base and 30% for private foundations.
- Contributions of “appreciated long-term capital gain property” to public charities are deductible based on fair market value, up to 30% of the contribution base (or 50%, if an election is made to limit the deduction to the grantor’s cost basis). Contributions to private foundations are limited to the grantor’s cost basis up to 20% of contribution base. However, in the case of publicly traded stock gifted to a private foundation, the deduction is based on fair market value, up to 20% of the contribution base.
- The treatment of tangible personal property, such as artwork or antiques, depends on whether the donated asset will be put to use related to the charitable purpose of the charity. For example, if a painting contributed to a college is placed in its library for display and study by art students, the purpose is related; if the painting is sold and the

proceeds used for educational purposes, the purpose is unrelated. The income tax deduction is the fair market value up to 30% of the contribution limit. However, generally the income tax deduction for tangible personal property is not available until the termination of the grantor's interest. But the deduction may be allowed at the time the CRT is created if the CRT meets strict statutory requirements.

- In addition to deduction limits based on the nature of the property and the nature of the charity, a distinction is made between contributions made "to" versus "for the use of" charity. Deductions for contributions made "to" charity are limited to a maximum of 50% of the contribution base. Contributions made "for the use of" charity are deductible to a maximum of 30% of the contribution base. The regulations provide that contributions to a CRT may be considered made "to" charity unless the interest is to be maintained in trust for the charity upon termination of the income interest.

Individual taxpayers who qualify for and elect to take the standard deduction cannot itemize their deductions and, thus, charitable contributions will not directly affect computation of their federal income tax. In addition, itemized deductions for high-income taxpayers are reduced by the lesser of 3% of adjusted gross income or 80% of otherwise allowable itemized deductions. Charitable contributions are among the taxpayer's itemized deductions that are subject to these limits. Also, deductions limited by the percentage limitations referenced above are eligible for a 5-year carryforward.

Normally, a grantor will not **recognize gain or loss upon transfer** of assets to a CRT. However, if an asset is subject to debt in excess of the grantor's basis, gain generally is recognized. Grantors can capitalize on the tax-exempt status of the CRT to defer capital gains tax on highly appreciated assets. Appreciated assets are gifted to the trust, which in turn sells the assets. Because the trust is tax exempt, it does not pay capital gains tax. It is important to not have a pre-arrangement to sell the assets at the time they are transferred to the CRT because the Internal Revenue Service could apply the "step transaction doctrine" and disregard the transfer to the CRT.

Income Tax – Non-charity Beneficiaries

IRC §664(b) sets forth an ordering procedure regarding how to determine the tax character of the payments to income beneficiaries: (1) ordinary income, (2) capital gains (the capital gains subject to the highest rate deemed distributed first), (3) other income (typically tax-exempt interest from state and municipal bonds), and (4) principal. If there is more than one recipient of the income distribution, each recipient will receive a pro rata share of each category.

Gift and Estate Tax

Gift Tax: If the grantor is not the only income beneficiary (such as per multi-generational CRTs), the annuity or unitrust payment may result in gift tax liability to the grantor. The amount subject to gift tax is the actuarial value of the interest created for other individuals. Such gifts may be eligible for the annual gift tax exclusion if the distributions begin immediately. If the only income beneficiary besides the grantor is the grantor's spouse, the transfer likely qualifies for the gift tax marital deduction.

Estate Tax: Two of the three following types of CRTs could be subject to estate tax: (1) a CRT in which the grantor is the only income beneficiary during life; (2) a CRT in which the grantor designates a successor income beneficiary at death; and (3) a testamentary CRT.

When the grantor is the only beneficiary, the retained income right would cause inclusion of the trust property in the grantor's estate, but the actuarial value of the charitable remainder would qualify for the estate tax charitable deduction. In the case of a CRT, the deduction generally equals the actuarial value of the charitable remainder.

However, when a successive non-charitable income beneficiary remains, the grantor's estate will include the amount necessary to yield the payment to that beneficiary. With respect to testamentary CRTs, likewise, estate tax liability would apply to the value of the income interest, but an estate tax charitable deduction would be available for the actuarial value of the charitable remainder. In both cases, if the only non-charitable beneficiary of the CRT is the grantor's spouse, the estate tax marital deduction should apply.

Generation Skipping Transfer Tax

Generation skipping transfer (GST) tax exemption cannot be allocated to transfers during any estate tax inclusion period (ETIP). The annuity term of a CRAT is an ETIP, meaning the grantor cannot allocate GST tax exemption to the trust until the earlier of the end of the annuity term or upon the grantor's death. A CRUT may be preferable if the trust will benefit skip persons, since the grantor can allocate GST tax exemption more efficiently on the initial transfer.

Income Tax Compliance

CRTs must file annually IRS Form 5227, Split-Interest Trust Information Return.