Charitable Remainder Trust Overview

DONOR TRANSFERS ASSETS TO TRUST
DONOR ENJOYS INCOME TAX DEDUCTION
RECIPIENT RECEIVES PAYMENTS FOR PERIOD OF TIME
CHARITY RECEIVES REMAINDER AT END OF TERM

Donor Transfers Asset to Trust

Types of assets donor might transfer

- Cash
- Stock
- Real Estate
- Tangible Personal Property
- IRA

Types of Assets

Cash

- Easy to value
- Easy to transfer

Stock

- Marketable
  - *Easy to value*
- Closely Held
  - *Requires appraisal*

Types of Assets

Real Estate

- Generally don't want to contribute mortgaged property
- Requires appraisal

Tangible Personal Property

- Not related to the exempt purpose of the charity
- Requires appraisal

Types of Assets

IRA

- Easy to value
- Easy to transfer

Recipient Receives Payments for Period of Time

Term

- Can be for lifetime of individual recipient(s) or for term of years
  - *Not to exceed 20*
  - *If for term of years, could be to different individual recipients*
- Combination or "Tacking"
  - *Can be for one life, then a succeeding life or period of years, whichever is shorter, as long as both recipients are alive at creation of trust*

Recipient Receives Payments for Period of Time

Unitrust

- Percentage payment to recipient each year
  - *Based on value of assets*
  - *Revalued each year to calculate next year's payment*

Annuity Trust

- Same payment to recipient each year

Recipient Receives Payments for Period of Time

NIMCRUT

- A unitrust may be designed to pay net income *or* the unitrust percentage whichever is greater
- If net income is less than what the unitrust payment would be, trust may "make it up" at some point

Recipient Receives Payments for Period of Time

FLIP

- Change to standard unitrust from net income unitrust
- Upon happening of a specific event
  - *Make up amount is forfeited*
- Example
  - *Donor contributes unmarketable land*
  - *Payment is net income only until sale of land*
  - *At that time the payment becomes standard unitrust payment*

Donor Enjoys Tax Deduction(s)

Trusts

- Must have certain provisions included in them

Income Tax Deductions

- For trust established during lifetime
  - *Calculated as the present value of what is expected to pass to charity at the end of the term*

Donor Enjoys Tax Deduction(s)

Information You Need to Have

- Term of Trust
  - *Number of years or*
  - *Recipient age(s)*
- Fair market value of donated asset
- Cost basis of donated asset
- Pay out rate
- Payment schedule
  - *Annually, quarterly, monthly*
- 7520 rate for the month (or preceding two) of the gift

Donor Enjoys Tax Deduction(s)

History Addressing Perceived Abuses

- Section 664
  - *1969 Congress passed rules setting forth highly technical requirements for how to qualify for charitable income tax deductions*
  - *Previously, charitable deductions were allowed even when a split interest trust could operate in a way that meant charity would receive little or nothing*

Donor Enjoys Tax Deduction(s)

The 7520 Rate

- Starting in 1989, the section of the Internal Revenue Code which proscribes valuation of a charitable interest to be 120% of the federal mid-term rate for the month of the valuation, or the preceding two months
- To calculate deduction if the payout term is the lifetime(s) of recipient
  - *Use the IRS life expectancy tables in IRS Publication 1458*

Donor Enjoys Tax Deduction(s)

Limitations

- In 1997 Congress imposed two additional requirements in order to qualify for an income tax deduction
- The %remainder - *Charity must receive at least 10% of the initial donation at the end of the term*
- The payout rate must be between 5% & 50%
  - *You can "back into" the maximum payout rate to confirm you do not flunk the 10% test*

Donor Enjoys Tax Deduction(s)

Limitations on the Income Tax Deduction

- Deduction ceiling
  - *50%, 30%, or 20% of donor's adjusted gross income*
  - *Can carry forward the balance for 5 years*

Donor Enjoys Tax Deduction(s)

- Deduction Reduction
  - Types of charitable donee
    - 50% charities
      - *Exempt organizations that are not private foundations*
      - *Private operating foundations*
      - *Supporting organizations*

Donor Enjoys Tax Deduction(s)

-Types of Property Contributed

- Appreciated long-term capital gain property
  - To 50% charity
    - *Full fair market value*
    - *Limited to 30% of AGI*
  - To other charity (e.g. private foundation)
    - *Reduced by 100% of gain attributable to remainder interest (unless marketable securities)*
    - *Limited to 20% of AGI*
- Ordinary Income Property
  - *Limited to donor's basis regardless of character of charity*

Donor Enjoys Tax Deduction(s)

- Terms of the gift
  - *If at end of term, property is held "for the use of" rather than distributed outright to charity, the deduction is limited to 30% of AGI*

Donor Enjoys Tax Deduction(s)

Gift/Estate Tax Deduction

- Calculated based on what the charity expects to receive at end of term
    - 5% exhaustion rule
        - *If probability that the charity will NOT receive any remainder value is more than 5% then there is no gift or estate tax deduction*
- No percentage limitations

Donor Enjoys Tax Deduction(s)

- Lifetime recipient's interest is subject to the gift or estate tax
- Depends on who lifetime recipient is, if:
    - *The donor, then no gift*
    - *Spouse, could qualify for gift/estate tax marital deduction*
    - *To donor and/or spouse, then on to child, gift calculated based on what child is expected to receive*
    - *Donor retains right to change lifetime recipient, gift could be incomplete for gift tax purposes*

Donor Enjoys Tax Deduction(s)

- Donor can retain right to change charitable beneficiary to a different charitable beneficiary
    - *Would cause inclusion in estate*
    - *If charity is qualified, decedent donor still gets full charitable gift/estate deduction*

Taxation

To Recipient

- Tier Rules
  - *First payment carries out ordinary income, then capital gains, then "other income" then principal*
  - *If distribution in kind, treated as sale of asset so trust deemed to recognize capital gain*

Taxation

To Donor

- *Generally not taxed on the transfer of appreciated property to the trust even if trust sells the asset, unless there is indebtedness in excess of donor's basis*

Taxation

To Trust

- Since 2006, a CRT is not subject to income tax
  - *If it has UBTI, it pays an excise tax of 100% on the UBTI*
  - *Before 2006, UBTI could make the entire trust taxable as a complex trust*
- Trust must file income tax return

Charity Receives Remainder at End of Term

Qualifying Charity

- Section 170(c) for income tax
  - *At end of trust term, remainder of trust must be distributed to an organization listed in Section 170(c*
- Section 2055(a) estate tax
  - *If goal is an estate tax deduction, charitable remainder beneficiary should be an organization described in 170(c) and 2055(a)*

Charity Receives Remainder at End of Term

Qualifying Charity

- Section 2522(a) gift tax
  - *If goal is a gift tax deduction, charitable remainder beneficiary should be an organization described in 170(c) and 2522(a)*
- Contingent Charity
  - *Trust can provide that if the chosen charity no longer exists, an alternating qualifying charity can be named beneficiary*

The Mechanics

Trust Instrument

- There must be a document
- Trustee
  - *Donor can be the trustee*
  - *But if a retained power causes grantor trust status, the trust ceases to qualify as a CRT*
  - *Can be challenging if there are hard to value assets*

The Mechanics

- Trustee (continued)
  - *Charity can serve as trustee*
    - Charity may invest the assets with their other assets with specific disclosures to donor
    - May be inherent conflict of interest for hard to value assets
    - Charity might agree to serve only if guaranteed a minimum percentage of assets at end of term
  - ***Might consider an independent trustee during period of time the assets are hard to value***

The Mechanics

- Required Elements
  - *The code has very specific requirements for what a CRT must and must not include*
  - *The trust provisions may need to specifically override state law*
- IRS sample forms
  - *IRS has included sample forms for a unitrust or annuity trust*
  - *Sample forms may not include everything the donor or state law requires and should be customized if used*

The Mechanics

Asset Transfers

- Once trust is prepared and signed, donor must transfer assets to trust
  - *Might be done via deed, request to broker to transfer certain stocks, or an assignment of a business interest or other asset*

Valuations

- Appraisals should be acquired for transfers or difficult to value assets by an independent appraiser

The Reasons to do it at all – What's in it for me?

<u>Compared to Doing Nothing</u>

- Outcomes:
  - *If the donor sells an appreciated asset, pays the income tax, and reinvests the proceeds*

    Vs.
  - *If donor transfers to CRT*
    - *The CRT sells, pays no tax, pays the recipient the unitrust or annuity payment*
    - *Recipient invests the payments*

The reasons to do it at all – What's in it for me?

- <u>Compared to doing nothing</u> *(continued)*
  - *Recipient enjoys income tax deduction*
  - *At some point, value of assets under CRT may be greater than if donor sold himself*
  - *Donor may achieve diversification of investments that he would not otherwise have*

The reasons to do it at all – What's in it for me?

- <u>Compared to gift annuity</u>
  - *Donor might have similar diversification results if he enters into a gift annuity arrangement with the organization*
  - *However, then donor can't change the charitable beneficiary and is limited to annuity form of payment*

The reasons to do it at all – What's in it for me?

- Tax Savings
  - *Income*
    - Donor may receive income tax deduction
    - Assets might be invested in tax exempt bonds
  - *Capital Gain*
    - Donor doesn't recognize gain on sale of appreciated assets, neither does trust

The reasons to do it at all – What's in it for me?

- Tax Savings (continued)
  - *Net Investment Income (NII)*
    - With new 3.8% Medicare surtax, sale of an appreciated asset by an individual might generate NII
    - If asset is donated to CRT and CRT sells, no gain is recognized
    - Payment made to recipient, not all in one year so NII avoided
  - *Gift/Estate Tax*
    - Assets are out of the estate for gift and estate tax purposes

The reasons to do it at all – What's in it for me?

- Wealth Replacement
  - *Donors who want to replace what will go to charity with assets that will pass to family members might be interested in using a portion of payments he receives to pay premium on a life insurance policy*