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CHARITABLE REMAINDER TRUSTS

What is a Charitable Remainder Trust?

A charitable remainder trust ("CRT") allows an individual (the "donor") to donate assets to a charity while retaining an interest in the donated assets or providing another individual or entity with an interest in the donated assets for a specified period of time. The non-charitable beneficiary of the CRT will receive a stream of payments for a specified period of time, and at the expiration of this period, the remaining assets will be transferred to the charitable beneficiary. The donor may obtain an income tax charitable deduction, and/or a gift tax charitable deduction or an estate tax charitable deduction.

Requirements for Charitable Estate, Gift and Income Tax Deductions

A charitable deduction is allowed only if the non-charitable beneficiary's interest is in the form of an annuity interest or a unitrust interest. Accordingly, a CRT may be established as a charitable remainder annuity trust (a "CRAT"), charitable remainder unitrust (a "CRUT"), or a net income CRUT.

Annual Payments. A CRAT pays a defined annuity, based on the initial fair market value of the trust assets, to the non-charitable beneficiary, at least annually, regardless of the value of the trust assets or the income generated by the trust. The amount paid must be equal to at least 5%, but not more than 50%, of the initial fair market value of the assets of the trust. Additionally, when the CRAT is created, there must be no more than a 5% chance that the required payments will exhaust the principal of the trust. Finally, the value of the remainder interest that passes to charity must be equal to at least 10% of the initial fair market value of the assets of the trust.

A CRUT pays a defined percentage of the net fair market value of the assets of the trust, valued as of a certain day each year, to the non-charitable beneficiary, at least annually. This amount is called the "unitrust amount." The percentage may not be less than 5% of the fair market value of the assets on the specified day and can be no more than 50% of such value. The value of the remainder interest that passes to charity must be equal to at least 10% of the fair market value of the assets of the CRUT as of the date the property is contributed to the CRUT. The unitrust amount fluctuates as the net fair market value of the CRUT assets fluctuates, even though the defined percentage is fixed. Therefore, unlike the CRAT, a CRUT will not be exhausted by distributions to the non-charitable beneficiaries because the unitrust amount will decrease as the value of the assets of the trust decreases.

A variation of the CRUT, called a net income CRUT, is a CRUT that pays the lesser of the income of the trust or the unitrust amount. The trust may provide for a payment in excess of the unitrust amount to "make up" for prior years in which the income was less than the unitrust amount.

The annuity or unitrust amount is fixed and may not change over time. No distributions for emergency needs or other purposes may be made from a CRT.

Beneficiaries of the CRT. The non-charitable beneficiaries of a CRT may include individuals, trusts, partnerships, corporations, or other legal entities that are not charities. The remainder beneficiary must be a charity.

Term of the CRT. If the non-charitable beneficiary is an individual, then the term of the CRT may be for either the duration of the beneficiary's life or not more than 20 years. In selecting the term of the CRT, however, the donor must bear in mind the requirements for the CRAT, discussed above, as to the probability of the exhaustion of trust assets and the amount that must be distributed to the charity at the end of the term. If the non-charitable beneficiary is not an individual, then the term of the CRT must be for a term of years not to exceed 20 years.

Tax Consequences

If the CRT is established during the donor's lifetime, the donor will be entitled to a charitable deduction for income tax purposes and for gift tax purposes. If the CRT is established upon the death of the donor (under the donor's will or revocable trust, for example), the donor's estate will be entitled to a charitable deduction for estate tax purposes.

Income Tax Consequences. If the CRT is established during the lifetime of the donor, an income tax charitable deduction will be available to the donor for the actuarial value of the charity's remainder interest in the CRT. The actuarial value is determined using the Internal Revenue Service's mortality tables and the interest rate prescribed by the Internal Revenue Code. The amount of the deduction will be determined by the type of property contributed to the CRT (cash or capital gain property) and the ultimate charitable beneficiary (public charity or private foundation).

Charitable remainder trusts generally are exempt from income taxes. Distributions to non-charitable beneficiaries, however, are taxed to the beneficiaries. In any year in which the trust has unrelated business taxable income ("UBTI"), the trust will forfeit its tax-exempt status, and all income realized by the trust for the year will be subject to income tax. UBTI usually results from income derived from a trade or business carried on by the charity that is unrelated to the charity's tax-exempt purposes.

Gift Tax Consequences. If the CRT is established during the donor's life, the donor is entitled to a charitable gift tax deduction for the actuarial value of the charity's remainder interest. If the only non-charitable beneficiary other than the donor is the donor's spouse, the gift tax marital deduction will be available. If the non-charitable beneficiary is not the donor's spouse, then the actuarial value of the beneficiary's interest will be subject to gift tax, and as long as the value of the gift is less than the donor's unused gift tax exemption, the donor will not have to pay any gift tax on the transfer of the interest.

Estate Tax Consequences. If the donor is a beneficiary of the CRT, then the CRT will be includible in the donor's gross estate for federal estate tax purposes.

If the CRT is established at the donor's death, an estate tax deduction will be available to the donor's estate for the remainder interest. If the only non-charitable beneficiary other than the donor is the donor's spouse, then the estate tax marital deduction will be available. If the non-charitable beneficiary is not the donor's spouse, then the actuarial value of the beneficiary's interest will be subject to estate tax, and the donor's unused estate tax exemption may be used to eliminate or reduce any estate tax.

Choice of Trustee

The donor may name any person, including the donor, or corporate fiduciary to act as trustee. If the trustee will have the power to make distributions among a class of non-charitable beneficiaries, if any hard to value assets are transferred to the trust, or if the trustee will sell appreciated assets that the donor contributed to the CRT, the trust may be disqualified if the donor or a party controlled by the donor is acting as trustee. Under these circumstances, the trust should provide that all discretionary powers, valuations of difficult to value assets, and sales of appreciated contributed property will be done by an independent trustee.

Choice of Assets to Contribute to a CRT

Caution should be used if the donor wishes to contribute unproductive or low-yield assets. A net income CRUT is a good candidate for such assets because it avoids mandatory unitrust payments in years in which the income yield on the trust assets is low. If the assets are sold and reinvested in more productive assets, then the trustee can begin to pay the full unitrust amount. A CRAT is a bad candidate for such assets because it requires the distribution of the specified amount regardless of whether the assets have generated income. Additionally, while additional property can be added to a CRUT to provide for the necessary payments, no additional property may be added to a CRAT.

As noted above, a CRT forfeits its tax-exempt status for any year in which UBTI is realized by the trust. Therefore, the donor must consider whether property contributed to a CRT will generate UBTI.

Using a CRAT or a CRUT

A CRAT may be preferred by individuals who are less tolerant to risk and are worried about deflation because the value of the annual annuity remains constant regardless of any increase or decrease in the value of the trust property. If the property contributed to the trust is difficult to value, a CRAT will be preferable because the asset only must be valued at the time of contribution rather than annually, as with a CRUT.

A CRUT may be preferred by individuals who are more risk tolerant and are worried about the effect of inflation, on the assumption that the fair market value of the assets will increase with inflation. As the fair market value of the assets increases, the unitrust payment increases. If the donor wishes to make additional gifts to the trust, a CRUT should be selected because no additional gifts may be made to a CRAT.

Private Foundation Rules

CRTs are subject to some of the restrictions on private foundations. Among these restrictions are a prohibition on certain transactions between the trust and the donor and certain other persons (known as “self-dealing”). For example, with certain exceptions, the sale or exchange of property between a CRT and a donor is self-dealing. These complex restrictions must be examined in detail to avoid excise taxes.

Conclusion

A CRAT or CRUT is an effective estate planning tool used to reduce income, gift and/or estate taxes while providing for an income stream to a non-charitable beneficiary and a remainder interest to a charity.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information regarding charitable trusts or any other estate planning options.