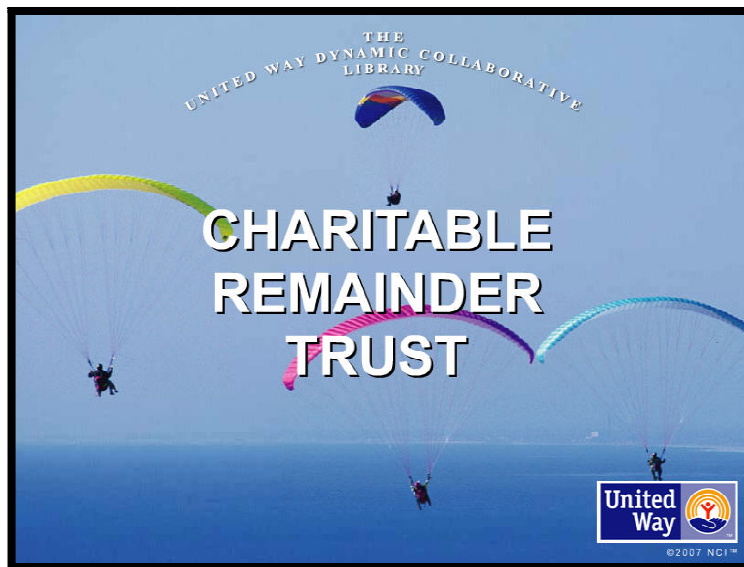


UNITED WAY DYNAMIC COLLABORATIVE™  
DONOR-STUDY SERIES



# CHARITABLE REMAINDER TRUST

QUESTIONS & ANSWERS



United Way of Central New Mexico



# Charitable Remainder Trust

## Q & A

*The following questions and answers are not meant to offer the reader legal, tax, accounting, or financial advice. While the legal, tax, accounting, charitable, and financial planning issues covered in the questions and answers have been checked with sources believed to be reliable, some material may be affected by changes in the laws or in the interpretations of such laws. For that reason the accuracy and completeness of such information and the opinions based thereon are not guaranteed. It is important that anyone who is interested in pursuing the establishment of a Charitable Remainder Trust seek out competent legal, tax, accounting, and financial advice before proceeding.*

### **What is a Charitable Remainder Trust (CRT)?**

A CRT is an irrevocable trust that pays a percentage of the trust principal to named individuals and then distributes the remainder — whatever assets remain in the CRT when it ends — to charity.

CRTs are specifically allowed in the Internal Revenue Code and are an established and safe way to make major gifts to charity.

### **Why would I create a CRT?**

There are a number of reasons for using a CRT. First and foremost, you must be charitably-minded. Although CRTs have a number of tax and financial advantages, they are not usually substantial enough to justify creating a CRT.

#### *Charitable Reasons for Creating a CRT:*

- The maker of a CRT can receive recognition for the gift during his or her lifetime, even though the charity will not receive the gift until later
- The maker can leave a legacy to his or her favorite charity or charities, or even to his or her own foundation

#### *Financial and Tax Planning Reasons for Creating a CRT:*

- There is an immediate income tax deduction for assets given to a CRT
- Assets held in a CRT, if sold for a gain, are not subject to income taxation

- Selling assets in the CRT allow the maker to diversify his or her portfolio by selling contributed assets and reinvesting the proceeds without having to pay capital gain tax
- The maker can often increase his or her income above what the original asset was generating before it was sold by the trust
- The income beneficiary of a CRT can receive an income interest in the trust for a term of years or for his or her life; if there are multiple income beneficiaries, then the term can last until the last one of them dies
- When the term of the CRT ends, whatever assets remain in the CRT pass to a charity or charities, free from federal estate tax
- The maker can control the investments held in the CRT, so long as certain technical restrictions are met

### **What types of property can be given to a CRT?**

Not all types of property are desirable for use in a CRT. Cash, appreciated securities, and appreciated, unencumbered real estate are excellent choices. It is possible to contribute non-publicly traded stock, tangible personal property, such as paintings, and other assets into a CRT. It is extremely important that anyone contemplating the use of a CRT seek out highly skilled and experienced lawyers, accountants, and financial advisors before committing to the use of a CRT to make a major gift.

### **Why doesn't a CRT have to pay income tax on its income?**

A CRT is a tax exempt trust under provisions of the Internal Revenue Code. As such, it pays no income tax on the sale of assets or on most types of income that are generated by trust assets. However, under some circumstances penalty taxes may be due if a certain type of income, called Unrelated Business Taxable Income (UBTI) is generated. Remember to work very closely with your tax advisor to make sure that the investments in your CRT do not generate UBTI.

### **How is the income tax deduction determined for a gift to a CRT?**

The amount of the income tax deduction you receive is based on a number of factors. The deduction is not equal to the current value of the assets that you give to your CRT. Rather, it is

equal to the present value of the assets that you fund your trust with. The present value of the assets is determined by a formula that takes into consideration the following elements:

- The type of CRT used
- The value of the assets contributed to the CRT
- The amount of income that will be taken out by the income beneficiary
- The age of the maker or makers of the CRT
- The term of the CRT (lifetime or a term of years)
- Current interest rates

### **Why are current interest rates relevant to the determination of the income tax deduction?**

The present value of the assets contributed to a CRT is the value today of what charity might receive in the future. This present value amount is only a calculated guess, because no one knows what is going to happen in the future. To make the best guess possible (the amount of the current income tax deduction hinges on it), a number of assumptions must be made. One of the assumptions is what rate of return the CRT assets are going to produce over its term. For decades the Internal Revenue Service, the courts, and tax practitioners have wrestled with the problem of coming up with a fair rate of return. The solution that is now part of our law is that the government publishes an assumed rate of return every month called the “applicable federal rate.” It is this rate that is used as one of the factors to determine the present value of the assets. It is not a perfect system, but at least it is a consistent and understandable way to make a calculated guess.

### **How do all these factors work together to come up with the present value?**

The beginning point is the fair market value of the assets to be contributed to the CRT. This is established by qualified appraisal or, in the case of publicly-traded securities, their established value. Second is the assumed growth rate – the applicable federal rate. Next is the percentage of the trust that is going to be paid out to the income beneficiaries – the payout rate. If the payout rate exceeds the applicable federal rate, then the trust is going to run out of money. So, the spread between the payout rate and the applicable federal rate is very important. Every bit as important is how long the CRT will last. If the CRT is going to last for the life of the maker, then his or her age and therefore life expectancy are necessary factors. If the CRT is for a term of years, that term must be specified in the trust. Finally, since there are two different types of CRTs, the one chosen must also be taken into consideration.

***The good news is that there are a number of software programs that easily and quickly compute the income tax deduction for a contribution into a CRT.*** Your advisors will have access to these programs and can readily give you a close estimate of what your deduction is.

### **Are there different types of CRTs?**

Yes, there are two primary types of CRTs, the **Charitable Remainder Annuity Trust (CRAT)** and the **Charitable Remainder Unitrust (CRUT)**. The main factor that differentiates the two is how the income interest is paid out.

In a CRAT, the income interest is paid out as an annuity. An annuity is a fixed payment, which does not change during the term of the CRAT. For example, if there is an initial contribution to a CRAT of \$1,000,000 and the payment amount is 6%, then the annuity amount is \$60,000 per year for that year and every year thereafter.

In a CRUT, the income that is paid out is based on the value of the assets held in the trust, which is called a unitrust payment. A 6% CRUT would pay out 6% of the yearly value of the trust assets. If \$1,000,000 was given to the CRUT in the first year, the payout would be \$60,000. However, if the value of the trust was \$1,200,000 in the second year, the payout would be \$72,000, which is 6% of \$1,200,000.

### ***What are some of the advantages of using a CRAT?***

The major benefit of a CRAT is that the income beneficiaries are protected from a decrease in the value of trust assets. As such, a CRAT is often beneficial for individuals who want to be able to count on a fixed income and to be free from market fluctuations.

### **Are there any drawbacks to using a CRAT?**

Because an annuity payment is fixed, there are three primary drawbacks to using a CRAT:

1. The income beneficiaries do not benefit from any appreciation of the value of the trust's assets
2. Inflation may erode the purchasing power of the annuity payment
3. No additional contributions can be made to a CRAT, so if the value of the assets decrease, the maker cannot supplement them

### **Who are the best candidates for a CRAT?**

CRATs generally appeal to older donors who prefer fixed, predictable annual payments.

### **What are the benefits of using a CRUT?**

The primary advantage of using a CRUT is that it provides a hedge against inflation because the annual payment is calculated on the value of the trust assets each year.

A second, but very important advantage of a CRUT is that hard-to-sell assets can be given to a special type of CRUT, called a **Charitable Remainder Unitrust with Net Income Makeup Provisions (NIMCRUT)**. Unlike a **Standard CRUT**, which requires a payout of a certain percentage of the assets every year, a NIMCRUT allows the deferral of income. For example, if a donor gave a building to a NIMCRUT and it was not sold for several years, the NIMCRUT would account for the income, but not pay it out. After the building was sold, the NIMCRUT trustee would “make up” the unitrust amounts that were not previously paid. The advantage for the maker of the NIMCRUT is that he or she could get the income tax deduction when the building was put into the NIMCRUT without having to worry about an immediate sale.

### **What would happen if a Standard CRUT did not create any income in a given year?**

In a Standard CRUT that did not generate enough income to pay the unitrust amount, the trustee must use principal to make the payment. This would reduce the value of the trust principal in the following year. This in turn would reduce the unitrust amount for that year because the unitrust amount is paid based on the value of the principal.

Unlike a CRAT, the trust maker of a CRUT can make additional contributions to his or her CRUT to try to earn enough income to make the unitrust payment. These additional amounts are deductible in the same manner as the original contribution.

### **My understanding is that in addition to a Standard CRUT and a NIMCRUT; there is a third type of CRUT. What is this CRUT and what does it do?**

The third type of a CRUT is a **CRUT with “flip” provisions (FLIPCRUT)**. A FLIPCRUT is a CRUT that begins as a NIMCRUT but then changes (flips) into a Standard CRUT.

### **Why would I want to use a FLIPCRUT?**

FLIPCRUTs are used by charitable donors who contribute real property (land or land and a building) to a CRUT.

Let’s assume that you contribute a \$500,000 parcel of vacant land to a FLIPCRUT with a provision that it switches to a Standard CRUT when the property is sold. The trustee of the FLIPCRUT does not sell the property for two years, so there is no income to pay and the trust owes you two years of unitrust payments. The trustee sells the property in the third year,

which triggers the flip to a Standard CRUT. The trustee then invests the proceeds in income-producing assets that will generate enough income to make the stated unitrust payments. Depending on the time of the sale and your wishes, you may or may not receive the makeup amount from prior years, but the restrictions on paying income in the future are removed.

### **How are annuity and unitrust payments taxed to the income beneficiaries?**

There is a relatively complex method for taxing annuity and unitrust payments received from a CRT. This requires the trustee to keep detailed financial records from the very beginning of a CRT.

Amounts paid from a CRT are taxed in the following order:

1. First, as ordinary income, to the extent that the trust has ordinary income for the current year and any undistributed ordinary income from prior years.
2. Second, once all of the ordinary income has been distributed, the payment is taxed as long-term capital gain to the extent the trust has capital gain for the current year and any undistributed capital gain from prior years.
3. Third, once all of the ordinary income and capital gain income has been exhausted, then the payment is treated as other income, such as tax-exempt income from municipal bonds, to the extent that the trust has other income for the current year and any undistributed other income from prior years.
4. Fourth, as a tax-free return of capital.

As a practical matter, with few exceptions, the income received from a CRT is likely to be ordinary income or capital gain income.

### **Can more than one person establish a CRT?**

Yes. It is very common that spouses create a joint CRT. In addition, CRTs can have several makers and they do not have to be related. However, there are complications and establishing these CRTs take a high degree of expertise.

### **Who can be the income beneficiaries of a CRT?**

Typically, the maker of a CRT is the income beneficiary. If a husband and wife are the makers, they are usually the income beneficiaries. A maker of a CRT can name virtually any income beneficiary, but there are gift tax implications. Legal, accounting, and financial advice are

critically important before establishing a CRT, especially if the income beneficiary is other than the maker.

### **Who can be the trustee of a CRT?**

Most trust makers name themselves and their spouses as the trustees of their CRTs. As trustees, they can retain control of their trust assets during their lifetime. If they do not wish to be involved in the administration of the trust, they name a corporate or institutional trustee. If the makers choose to act as their own trustees, they may be required to name a special independent trustee in their trust documents to perform specific trust duties.

### **What is the role of a special independent trustee?**

An independent trustee is someone who makes decisions in the following situations:

- When the trust maker contributes an asset that is hard to value
- When the trustee must make a decision to distribute income derived from a variable annuity owned by the trust
- When the terms of the CRT authorize the trustee to make discretionary annuity or unitrust distributions to the income beneficiaries

The independent trustee must truly be independent, meaning that the trustee cannot be related to, or controlled by, or employed by the trust maker.

### **What factors should be considered when naming the trustee of a CRT?**

CRTs are technical documents that must closely follow the law. They can also be particularly complicated with regard to accounting issues. If the trust is not properly administered, there can be adverse tax consequences for the donor, including subsequent disqualification as a CRT.

Because of the experience required with investments, accounting, and government reporting, every person who establishes a CRT should consider naming a corporate trustee to act as the sole trustee or a co-trustee with maker. For those who would like to act as their own trustees, it is often wise to retain the services of a trust administrator to handle the accounting and reporting tasks. The ultimate choice of a trustee or administrator is best made in consultation with professional advisors.

### **How should the term of a CRT be structured?**

A CRT can be set up to pay the annuity or unitrust payment for the life or lives of the income beneficiaries or for a term of years, not to exceed 20. Within these alternatives, there are other choices:

- A CRT can pay one beneficiary for his or her lifetime only, with the remainder passing to charity when the beneficiary dies.
- A CRT can have a “joint-and-survivor” payout, which means the CRT will pay two or more beneficiaries – usually spouses – for their lives, until the death of the last beneficiary. At that time, the balance of the funds passes to charity.
- A CRT can pay one or more beneficiaries for a specific number of years, not to exceed 20. Thereafter, the balance of the funds passes to charity.
- A CRT can use a combination of a term of years with a life term, but extreme care must be taken because the rules are complex.

### **How much income can be taken from a CRT?**

The Internal Revenue Code requires that the annuity and unitrust payout rates be at least 5% but not more than 50% per year, although the maximum payout rate is rarely used. Most CRTs have a single digit payout rate. The payout rate chosen is generally a function of:

- The amount of income tax deduction that is required (the lower the payout the higher the deduction)
- How much money the income beneficiaries want during the term of the CRT
- The current interest rate environment

If the income beneficiaries do not need the cash to live on, a low payout rate is preferable. A lower payout rate increases the amount of the charitable income tax deduction. However, if the income beneficiaries need a certain amount of income each year, then the payout should be adjusted so it is large enough to cover the need. A higher payout decreases the charitable income tax deduction.

The earnings and appreciation in excess of the annual payout amount grow tax-free inside the trust. In a CRUT, this results in the income beneficiaries receiving a greater sum over the term of the trust with a lower payout rate than they would have with a higher payout rate.

Anyone who is contemplating a CRT should work with their advisors to “run the numbers,” so that there is a complete understanding of the different payout rates and their effect over time.

### **Is there a certain amount that must be left to charity?**

To qualify as a CRT, the present value of the amount *expected* to pass to charity must be at least 10% of the initial contribution. This “10% test” is applicable when the trust is formed; there is no guarantee of the amount that will actually be received by the charity.

There is a slight difference here between the CRUT rules and the CRAT rules. The maker of a CRUT is allowed to make additional contributions to his or her CRUT. Each time a contribution is made, the 10% test is applied to that contribution. Since additional contributions cannot be made to a CRAT, the test is only applied once – when the initial contribution is made.

A CRAT faces a second test. A CRAT pays a constant percentage of the trust assets, valued when they were initially contributed to the trust, no matter how much the trust assets grow or decline in value over time. Therefore, if the trust’s investments do not perform well over time, a CRAT may eventually run out of funds and there will be nothing left for charity. To avoid this result, the mathematical possibility that the CRAT will be exhausted before distribution to charity cannot exceed 5%. This computation must be made prior to establishing a CRAT or the CRAT will be invalid.

While these tests may seem daunting, they are not. There are many software programs that can run these tests in a matter of seconds based on various scenarios. Your major gift advisor has access to them and, with the help of your other advisors, can advise you as to the limitations that you may, if any.

### **How often can payments be made from a CRAT or CRUT?**

The income beneficiaries must receive at least one payment a year, but the payments can be semi-annually, quarterly, or monthly. In addition, the payments can be received at the beginning of one of these periods or at the end. The choice of when the payments are made does affect the charitable income tax deduction.

### **What kinds of charities can be named in a CRT?**

The charities must be qualified charitable beneficiaries, as defined by the Internal Revenue Code in Section 170(c). These include public charities, supporting organizations, donor-advised funds and private foundations.

### **Can more than one charity be named?**

Yes. There is no limitation on the number or how much is given to each.

### **Can the charities named be changed?**

The maker of a CRT can retain the right to change the charitable beneficiaries, but this right must be contained in the CRT document. This right can also be given to the trustee or to other income beneficiaries.

If this provision is not in the CRT document, the charities are irrevocable.



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