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A Primer on Charitable Remainder Trusts

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INTRODUCTION

With income tax rates as high as 39.6% and an additional 3.8% tax on net investment income, on the one hand, and a 40% federal transfer tax rate and a \$5,000,000 estate tax exemption indexed annually for inflation (\$5,340,000 in 2014), on the other hand, individuals are increasingly shifting their focus toward estate planning techniques that provide not only future estate tax benefits, but also immediate income tax benefits. For those individuals who are charitably inclined, a charitable remainder trust may be an excellent vehicle to reduce future estate tax, obtain an immediate income tax deduction, and benefit charity.

As its title suggests, this Article is intended to serve as a general primer on charitable remainder trusts, setting forth the basics that all estate planners should know in order to effectively advise their clients.

WHAT IS A CHARITABLE REMAINDER TRUST?

Generally speaking, a charitable remainder trust (a “CRT”) is an irrevocable trust to which an individual

(a “donor”) makes a gift of property and designates at least one non-charitable beneficiary (which may be the donor or another person) as the income beneficiary and at least one qualifying charity as the remainder beneficiary. The trust must pay to the non-charitable beneficiary either (a) a stated dollar amount or a fixed percentage of the assets contributed to the trust valued at the time of contribution (an “annuity”) or (b) a fixed percentage of the assets contributed to the trust valued annually (a “unitrust amount”) for the non-charitable beneficiary’s life (or the lives of one or more non-charitable beneficiaries) or a term of years not to exceed 20 years. Upon the death of the non-charitable beneficiary (or the last surviving non-charitable beneficiary if more than one) or the termination of the term, the assets remaining in the trust will pass to the designated charity.

WHY USE CRTs?

If properly structured and administered, a CRT provides several significant benefits to the donor. Specifically, a CRT will (a) provide the donor (or other income beneficiary) with an income stream, (b) remove the gifted assets from the donor’s taxable estate, (c) provide the donor with a current income and gift (or estate) tax charitable deduction, (d) permit the tax-free growth of assets within the CRT, (e) permit the sale of appreciated assets without immediate gain recognition, and (f) accomplish charitable goals. The details of the tax benefits associated with the creation of a CRT are discussed below.

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Income Tax Deduction

When a donor contributes assets to a CRT, he or she should be entitled to a current income tax charitable deduction.² The amount of the deduction is equal to the present value of the charitable remainder interest (the “deductible amount”).³ Generally, the fair market value (“FMV”) of the contributed property is used to determine the deductible amount.⁴ However, the FMV of the contributed property must be reduced by any built-in gain that is not long-term capital gain (e.g., ordinary income and short-term capital gain).⁵ Additionally, as a general rule, if the remainder beneficiary of the CRT is a private non-operating foundation, the FMV is further reduced by any built-in long-term capital gain, thus requiring the contributed property’s basis (rather than FMV) to be used in determining the deductible amount.⁶ An important exception to this rule permits FMV to be used in determining the deductible amount if the contributed property to a private non-operating foundation is “qualified appreciated stock.”⁷ “Qualified appreciated stock” is defined as stock of a corporation “(i) for which (as of the date of contribution) market quotations are readily available on an established securities market, and (ii) which is capital gain property,” provided that the aggregate amount of stock contributed by the donor and his or her family does not exceed 10% in value of the total outstanding stock of the corporation.⁸

The extent to which the donor may deduct the deductible amount on his or her income tax return is dependent upon two factors: (1) the type of property transferred to the CRT; and (2) the type of charity named as the remainder beneficiary of the CRT. Generally, if the donor contributes cash to the CRT, the deductible amount is limited to 50% of the donor’s adjusted gross income (“AGI”) for the taxable year if the remainder beneficiary is a public charity and 30% of the donor’s AGI for the taxable year if the remainder beneficiary is a private foundation.⁹ If the donor contributes appreciated capital assets to the CRT, the

deductible amount is limited to 30% of the donor’s AGI for the taxable year if the remainder beneficiary is a public charity¹⁰ and 20% of the donor’s AGI for the taxable year if the remainder beneficiary is a private foundation.¹¹ Any portion of the deductible amount that is not allowed as a deduction in the year of contribution carries forward for five years and can be used to offset income in such years.¹²

Gift Tax Deduction

In addition to a current income tax charitable deduction, the donor should also be entitled to a gift tax charitable deduction.¹³ The amount of the gift tax charitable deduction is the same as the amount of the income tax charitable deduction; however, there is no limitation on the amount of the deduction. Thus, if the non-charitable beneficiary is the donor or the donor’s spouse, the transfer to the CRT should have no gift tax consequences to the donor. However, if the non-charitable beneficiary is someone other than the donor or the donor’s spouse, the donor would be treated as making a taxable gift to the non-charitable beneficiary in an amount equal to the present value of the annuity or unitrust amount.

Estate Tax Deduction

If a CRT is created under the Last Will and Testament or revocable trust of the donor, then the donor’s estate will be entitled to an estate tax charitable deduction equal to the actuarially determined fair market value of the charitable remainder interest in the trust.¹⁴ A testamentary CRT is deemed to have been created on the date of the decedent’s death and therefore the fair market value of the charitable remainder interest in the trust is determined as of the date of death, even though the trust may not be funded until the estate administration has been completed.¹⁵

Additionally, if the assets of an inter vivos CRT are included in the donor’s gross estate for estate tax purposes, the donor should be entitled to an estate tax charitable deduction.¹⁶ The assets of a CRT would be included in the donor’s gross estate if the donor re-

² See §170(a), §170(f)(2). Unless otherwise specified, all “Section” or “§” references refer to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

³ See Reg. §1.664-2(c), §1.664-3(c), §1.664-4.

⁴ Reg. §1.170A-1(c)(1).

⁵ §170(e)(1)(A).

⁶ §170(e)(1)(B)(ii).

⁷ See §170(e)(5).

⁸ §170(e)(5)(B), §170(e)(5)(C). The IRS has addressed the scope of the definition of qualified appreciated stock in several private letter rulings, including: PLR 200702031 (shares traded on Over-the-Counter Bulletin Board); PLR 200322005 (American Depository Shares); PLR 199925029 (mutual fund shares); PLR 9247018 and PLR 9441032 (Rule 144 stock).

⁹ §170(b)(1)(A), §170(b)(1)(B).

¹⁰ The taxpayer may elect to have the 50% AGI limitation apply in lieu of the 30% AGI limitation; however, if such an election is made, the deductible amount is determined using the contributed property’s basis rather than its FMV. See §170(b)(1)(C)(iii).

¹¹ §170(b)(1)(D).

¹² §170(b)(1)(B).

¹³ §2522(a), §2522(c)(2)(A).

¹⁴ §2055(a).

¹⁵ Reg. §1.664-1(a)(5).

¹⁶ §2055(a), §2055(e)(2)(A).

tains an income interest in the CRT for life (or for a term of years and dies during such term) or if the donor retains the testamentary power to alter the non-charitable income beneficiary or the charitable remainder beneficiary.¹⁷

Tax-Exempt Entity

A CRT is exempt from federal and state income tax and the 3.8% net investment income tax (the “NIIT”; sometimes referred to as “NII” when discussing income). This aspect of a CRT provides two significant benefits. First, the investments within a CRT grow undiminished by taxes and, therefore, grow at a much faster rate than taxable investments. Second, a CRT can sell highly appreciated assets without immediately recognizing gain. This makes CRTs especially attractive to individuals contemplating the sale of a highly appreciated asset. Rather than the individual selling the asset and recognizing immediate capital gains, the individual could contribute the asset to a CRT, retain an income interest for life and the CRT could sell the asset and reinvest the proceeds.

Determining the Amount of the Charitable Deduction

Many computer programs exist to assist practitioners in calculating the value of the charitable remainder interest of a CRT and the corresponding charitable deduction afforded to the donor. Despite the availability of these programs, all practitioners should have an understanding of the methods utilized by these programs in making such calculations.

Charitable Remainder Annuity Trusts

The value of the charitable remainder interest with respect to a charitable remainder annuity trust (a “CRAT”) is equal to the net FMV of the property contributed to the CRAT reduced by the present value of the annuity.¹⁸ This calculation is computed in the following manner:

Step 1 — Determine the Applicable Factor.

The factors for determining the present value of the annuity for a term of years are published in Pub. 1457, Table B, *Term Certain Factors*. The factors for determining the present value of an annuity for the life of a non-charitable beneficiary are published in Pub. 1457, Table S, *Single Life Factors*. In determining the applicable factor, you must use the Table that corresponds to the appropriate Section 7520 Rate, which will be the Section 7520 Rate for the month of

the transfer or either of the prior two months, whichever is highest.¹⁹

Step 2 — Determine the Present Value of the Annuity.

Once the applicable factor is determined, multiply the applicable factor by the amount of the annual annuity payout. This will give you the present value of the annuity.

Step 3 — Determine the Present Value of the Charitable Remainder Interest.

Subtract the present value of the annuity determined in Step 2 from the value of the property contributed to the CRAT. This will give you the present value of the remainder interest, which is also the amount of the charitable deduction.

Example: Donor, age 72, transfers assets having a \$1,000,000 FMV to a CRAT and retains the lifetime right to a 5% annuity. The Section 7520 Rate is 2.2%. The appropriate factor, determined under Step 1, is 10.7435. The present value of the annuity, determined under Step 2, is \$537,175 ($\$50,000 \times 10.7435$). The present value of the charitable remainder interest, determined under Step 3, is \$462,825 ($\$1,000,000 - \$537,175$).

Charitable Remainder Unitrusts

The determination of the value of the charitable remainder interest with respect to a charitable remainder unitrust (a “CRUT”) is a much more complicated calculation and is determined under Reg. §1.664-4(e) as follows:

Step 1 — Determine the Adjusted Payout Rate.

The adjusted payout rate (the “APR”) is determined by multiplying the fixed unitrust percentage (e.g., 5%) by a “payout factor” contained in Pub. 1458, Table F, *Actuarial Valuations Version 3B*. The purpose of Table F is to adjust the fixed unitrust percentage for the fact that the payout sequence of the unitrust affects the amount of principal that ultimately passes to charity. The more frequent the unitrust payments (e.g., monthly rather than annually), the smaller the present value of the charitable remainder interest because fewer assets will pass to charity.

In determining the APR, the Table that corresponds to the appropriate Section 7520 Rate must be used. From that Table, the APR that corresponds to the number of months from initial valuation of the assets

¹⁷ §2036(a).

¹⁸ Reg. §1.664-2(c).

¹⁹ Reg. §1.664-2(c), §1.7520-2(b). In order to use the Section 7520 Rate from one of the prior two months, an election must be made in the manner set forth in Reg. §1.7520-2(b).

in the first full taxable year of the trust to the first payout date must be used. For example, if the CRUT assets are valued on the first day of the taxable year and the unitrust amount is paid quarterly at the end of each quarter, you would select the APR that corresponds to at least three months but less than four months.

Step 2 — Determine the Valuation Factor.

The valuation factor is determined by matching the APR with the appropriate term of years or appropriate age of the measuring life. Valuation factors for a unitrust amount payable for a term of years are published in Pub. 1458, Table D, *Term Certain Factors*. Valuation factors for a unitrust amount payable for the life of an individual are published in Pub. 1458, Table U(1), *Single Life Factors*. If the exact APR is not found in the Tables, which is often the case, it is necessary to perform an interpolation calculation to determine the appropriate valuation factor.²⁰

Step 3 — Determine the Present Value of the Remainder Interest.

Multiply the appropriate valuation factor from Step 2 by the net FMV of the assets contributed to the CRUT. This will give you the present value of the remainder interest, which is also the amount of the charitable deduction.

Example: Donor, age 72, transfers assets having a \$1,000,000 FMV to a CRUT and retains the lifetime right to a 5% unitrust amount, payable quarterly on the last day of the quarter. The Section 7520 Rate is 2.2%. The CRUT assets are valued on January 1 of each year. The payout factor, determined under Step 1, is 0.986509. Accordingly the APR is 4.933% (5% × 0.986509). The valuation factor, determined under Step 2, is 0.55435.²¹ The present value of the remainder interest, determined under Step 3, is \$554,350 (\$1,000,000 × 0.55435).

QUALIFICATION REQUIREMENTS

For a trust to qualify as a CRT and be afforded the tax benefits discussed above, the trust must satisfy a

number of technical requirements at the time of creation and throughout its existence. In an attempt to create some clarity in this highly technical area, it may be helpful to view the various technical requirements as falling into one of three categories – (a) requirements relating to the non-charitable income interest, (b) requirements relating to the charitable remainder interest, and (c) additional requirements.

Non-Charitable Income Interest

The following requirements must be satisfied with respect to the non-charitable income interest.

Payment Type

The income interest payable to the non-charitable beneficiary must take the form of either an “annuity” or a “unitrust amount.” An income interest will be treated as an “annuity” if the trust agreement defines such income interest as a stated dollar amount or a fixed percentage of the assets gifted to the CRT valued at the time of contribution.²² An income interest will be treated as a unitrust amount if the trust agreement defines such income interest as a fixed percentage of the assets gifted to the trust valued annually.²³ A trust that defines the income interest as the greater of the annuity or the unitrust amount will not qualify as a CRT.²⁴

Payment Term

The annuity or unitrust amount (as the case may be) must be payable to the non-charitable beneficiary for either a term of years (not to exceed 20 years) or the life of the non-charitable beneficiary (or lives of one or more non-charitable beneficiaries).²⁵ If the annuity or unitrust amount is payable for the life or lives of one or more individuals, all such individuals must be living at the creation of the trust.²⁶ This rule is of particular importance when the non-charitable income interest is payable to a class of individuals. In such event, all individuals within the class must be alive at the creation of the trust.

For example, if the trust agreement provides that the annuity or unitrust amount is to be paid to the donor’s descendants for such descendants’ lives, the

²⁰ Reg. §1.664-4(e)(4), §1.664-4(e)(5).

²¹ The APR of 4.933% is not found in Table U(1). The closest APRs in Table U(1) are 4.8% and 5.0%. Therefore, an interpolation calculation must be performed using these two APRs to determine the appropriate valuation factor. The appropriate valuation factor is determined as follows: First, determine the difference between the valuation factors at a 4.8% APR and a 5.0% APR. In this example, the difference is 0.01221 (0.56247 – 0.55026). Second, the following equation must be solved for X: ((4.933% (actual APR) – 4.8% (the closest APR that is lower than the actual APR)) / 0.2%) × 0.01221 = X. In this example, X = 0.00812. Finally, determine the appropriate valuation factor by subtracting X (0.00812) from the valuation factor at a 4.8% APR (0.56247). This gives you a valuation factor of 0.55435.

²² §664(d)(1)(A); Reg. §1.664-2(a)(1)(ii), §1.664-2(a)(1)(iii).

²³ §664(d)(2)(A); Reg. §1.664-3(a)(1)(i).

²⁴ Reg. §1.664-1(a)(2).

²⁵ §664(d)(1)(A), §664(d)(2)(A). To avoid denial of the charitable deduction, it is imperative that the annuity or unitrust amount actually be paid to the non-charitable beneficiary. See *Estate of Atkinson v. Commissioner*, 309 F.3d 1290 (11th Cir. 2002), *aff’d* 115 T.C. 26 (2000) (denying the charitable deduction where the trustee failed to pay the annuity to the income beneficiary during her lifetime).

²⁶ Reg. §1.664-2(a)(5), §1.664-3(a)(5).

trust would not qualify as a CRT because it is possible that not all members of the class (i.e., the donor's descendants) are living at the time of creation of the CRT. If the donor desires to name a class of individuals as the non-charitable beneficiaries, the trust agreement should contain language limiting the class only to those individuals living at the creation of the CRT.²⁷

5% Minimum Value / 50% Maximum Value Rule

All CRTs, whether a CRAT or a CRUT, are required to pay to the non-charitable beneficiary each year an amount equal to at least 5%, but not more than 50%, of the net FMV of the assets gifted to the CRT determined as of the date of contribution (in the case of a CRAT) or annually (in the case of a CRUT).²⁸ This rule effectively places a floor and a ceiling on the percentage payout to the non-charitable beneficiaries.

Power to Terminate Interest

Generally, a trust will not qualify as a CRT if any person holds a power with respect to such trust that would cause the trust to be a grantor trust for income tax purposes.²⁹ Notwithstanding this rule, the settlor is permitted to retain a testamentary power to revoke or terminate the interest of any non-charitable beneficiary.³⁰

Charitable Remainder Interest

The following requirements must be satisfied with respect to the charitable remainder interest.

Permissible Beneficiaries

A trust is a CRT only if the remainder interest is payable to one or more permissible beneficiaries. For purposes of the CRT rules, a permissible beneficiary is any charitable organization described in §170(c).³¹ This typically includes public charities, private foundations and donor advised funds. As discussed above, the status of the charity designated as the remainder beneficiary will affect the extent to which the deductible amount can be deducted on the donor's income tax return.

²⁷ In certain situations, the annuity or unitrust amount may be paid to a trust for the benefit of a non-charitable beneficiary, rather than directly to such individual, provided that the only function of such trust is to receive and administer the annuity or unitrust amount received from the CRT for the benefit of the non-charitable beneficiary and, upon such beneficiary's death, the assets will be included in his or her gross estate. *See* Rev. Rul. 2002-20, 2002-1 C.B. 794; Rev. Rul. 76-270, 1976-2 C.B. 194.

²⁸ §664(d)(1)(A), §664(d)(2)(A).

²⁹ Reg. §1.664-2(a)(3)(ii).

³⁰ Reg. §1.664-2(a)(4), §1.664-3(a)(4).

³¹ §664(d)(1)(A), §664(d)(2)(A).

10% Present Value Requirement

The present value of the charitable remainder interest must be equal to at least 10% of the net FMV of the property gifted to the CRT as of the date the property is contributed to the CRT.³² With respect to a CRUT, to which, as discussed below, additional contributions are permitted, this test must be satisfied with respect to each contribution.³³ In order to prevent an additional contribution from inadvertently disqualifying a CRUT as a CRT, if an additional contribution to a CRUT causes the CRUT to fail the 10% present value requirement, such additional contribution will be treated as a transfer to a separate trust.³⁴ The separate trust will not qualify as a CRT; however, the existing CRUT will continue to qualify as a CRT.

Satisfying the 10% present value requirement becomes more difficult when the non-charitable beneficiary is relatively young, the Section 7520 Rate is relatively low, or the annuity or unitrust amount is payable to multiple beneficiaries (e.g., the joint lives of husband and wife).

Exhaustion Test

The Exhaustion Test, which is set forth in Rev. Rul. 77-374,³⁵ provides that a trust will fail to qualify as a CRT if there is a greater than 5% probability that the trust assets will be exhausted prior to the termination of the non-charitable interest. That is, if there is a greater than 5% probability that the charitable remainder beneficiary will receive no assets, the trust is not a CRT. The Exhaustion Test applies only to CRATs. The very nature of a unitrust amount (i.e., a fixed percentage of the assets determined annually) makes it impossible to exhaust the assets of a CRUT.

In low-interest-rate environments, the requirement that the non-charitable income interest have a value equal to at least 5% of the FMV of the assets contributed to the CRAT makes satisfying the Exhaustion Test difficult and prevents younger individuals from being designated as the non-charitable beneficiary. For example, assuming a Section 7520 Rate of 2.2% and a 5% annual annuity, a CRAT cannot satisfy the Exhaustion Test unless the non-charitable beneficiary is at least 71 years old.

The American College of Trust and Estate Counsel ("ACTEC") is currently working on a legislative proposal that would make CRATs available to a larger, younger population. Under the ACTEC proposal, the 5% Minimum Value Requirement would be revised to require a minimum annual payout to the non-

³² §664(d)(1)(D), §664(d)(2)(D).

³³ §664(d)(2)(D).

³⁴ §664(d)(4).

³⁵ 1977-2 C.B. 329.

charitable beneficiary equal to the lesser of (a) the Section 7520 Rate used to determine the value of the charitable remainder interest, and (b) 5%. For example, under the proposal, the minimum value of the non-charitable income interest of a CRAT created at a time when the Section 7520 Rate is 2.2% would be 2.2% (rather than 5%) of the FMV of the assets contributed to the CRAT. This would permit any individual at least 1 year of age to be the non-charitable beneficiary of a CRAT.

Power to Change Beneficiaries

The settlor of a CRT may retain the power to change charitable beneficiaries.³⁶ Additionally, the trustees and the income beneficiaries may also be granted the power to change charitable beneficiaries.³⁷ This creates a great deal of flexibility, as the charitable remainder beneficiary of a CRT can be changed after the trust is created to take into account future change in circumstances or donor intent.

Additional Requirements

In addition to the requirements that apply with respect to the non-charitable income interest and the charitable remainder interest, the following requirements also must be satisfied.

Prohibition on Other Payments

A CRT may not distribute any amounts to the non-charitable beneficiaries other than the annuity or unitrust amount.³⁸ This prohibition does not prevent sales to non-charitable beneficiaries for full and adequate consideration, provided that the non-charitable beneficiary is not a “disqualified person” under the self-dealing rules.³⁹

Additional Contributions

One distinguishing feature between a CRAT and a CRUT is that a CRAT must expressly prohibit additional contributions,⁴⁰ whereas a CRUT may permit additional contributions.⁴¹ If a CRUT permits additional contributions, the trust agreement must provide special rules for valuing the additional contributions for purposes of calculating the unitrust amount.⁴² Generally, where no valuation date occurs after the date of the additional contribution and during the tax-

able year in which the additional contribution is made, the additional contribution is valued as of the date of contribution.⁴³ The unitrust amount for the taxable year during which the additional contribution is made is then determined by taking into account only that portion of the value of the additional contribution attributable to the days in the taxable year after such additional contribution.⁴⁴ Any income earned by the additional contribution after the CRUT’s regular valuation date is disregarded in computing the unitrust amount.⁴⁵

Valuation of “Unmarketable” Assets

If a CRT owns “unmarketable” assets, whenever the CRT is required to value such assets (either at the time of contribution or annually with respect to a CRUT), the valuation must be (1) performed exclusively by an “independent trustee” or (2) determined by a qualified appraisal.⁴⁶ For purposes of this rule, “unmarketable” assets are assets that are not cash, cash equivalents or other assets that can be readily sold or exchanged for cash or cash equivalents.⁴⁷ An “independent trustee” is a person who is not the settlor, a non-charitable beneficiary, or a related or subordinate party to the settlor, the settlor’s spouse, or a non-charitable beneficiary.⁴⁸

The application of this rule must be carefully considered when deciding who will serve as the CRT’s trustee. If the CRT does not have at least one independent trustee, a qualified appraisal will need to be obtained any time the CRT’s assets need to be valued. This generally is not an issue with respect to contributions to either a CRAT or a CRUT because the charitable deduction rules require qualified appraisals

⁴³ *Id.*

⁴⁴ *Id.* For example, assume that on March 2, A makes an additional contribution to a calendar year CRUT, which has a January 1 valuation date and provides for a 5% unitrust amount. For purposes of computing the required payout with respect to the additional contribution for the year of such contribution, the additional contribution is valued on March 2. Assume further that on March 2, the additional contribution had a FMV of \$5,000. The required payout with respect to the additional contribution for the year of such contribution is \$208 (5% × \$5,000 × 305 days / 365 days).

⁴⁵ *Id.*

⁴⁶ Reg. §1.664-1(a)(7).

⁴⁷ Reg. §1.664-1(a)(7)(ii). Reg. §1.664-1(a)(7)(ii) lists the following examples of unmarketable assets: “real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.”

⁴⁸ Reg. §1.664-1(a)(7)(iii). Under §672(c), if nonadverse, the following individuals are treated as “related or subordinate”: (i) the settlor’s spouse, father, mother, issue, brother or sister; (ii) an employee of the settlor; (iii) a corporation or any employee of a corporation in which the stock holdings of the settlor and the trust are significant from the viewpoint of voting control; and (iv) a subordinate employee of a corporation in which the settlor is an executive.

³⁶ Rev. Rul. 76-8, 1976-1 C.B. 179.

³⁷ Rev. Rul. 76-7, 1976-1 C.B. 179.

³⁸ §664(d)(1)(B), §664(d)(2)(B).

³⁹ See discussion of private foundation rules, below.

⁴⁰ Reg. §1.664-2(b). For purposes of this rule, all property passing at death is treated as a single contribution, even if funding of the CRT requires several transfers.

⁴¹ Reg. §1.664-3(b).

⁴² *Id.*

for any contribution in excess of \$5,000.⁴⁹ Where the effects of this rule can really be felt is with annual valuations of CRUT assets. If no independent trustee is serving, the CRUT will need to obtain a qualified appraisal every year to value its assets. This can become a costly administrative burden. This rule may also be applicable where a CRAT does not have sufficient income in a given year to satisfy the full amount of the annuity payment and thus must distribute a portion of its principal.⁵⁰ To avoid this result, where the donor prefers to have a related or subordinate person serve as trustee, consideration should be given to appointing a special independent trustee solely for the purpose of determining asset value.

TYPES OF CHARITABLE REMAINDER TRUSTS

CRTs take several different forms, the effectiveness of each depending on the client's particular facts and circumstances. The primary characteristic distinguishing the various forms of CRTs is the manner in which the non-charitable income interest is defined. In order to effectively serve clients, planners must have a working knowledge of the differences between the various types of CRTs and the situations in which each form is best utilized.

Charitable Remainder Annuity Trusts

A CRAT is a CRT that pays to the non-charitable beneficiary an annuity (i.e., a stated dollar amount or a fixed fraction or percentage of the FMV of the trust assets determined as of the date of contribution). The annuity is paid to the non-charitable beneficiary regardless of whether the trust has "income"⁵¹ for the year. Accordingly, if the income of the trust for any particular year is less than the annuity, the trustees will be required to distribute principal to the non-charitable beneficiary to satisfy the annuity. This would be administratively burdensome and, depending on the nature of the CRAT's assets and the identity of its trustees, could necessitate costly appraisals.

Because the annuity is determined as of the date of the initial contribution, the annuity remains constant over the non-charitable term. This fixed nature of the annuity is a double-edged sword — protecting the non-charitable beneficiary against any decrease in asset value (i.e., the non-charitable beneficiary receives the full annuity even if the assets depreciate signifi-

cantly in value) yet preventing the non-charitable beneficiary from benefiting from any increase in asset value (i.e., all appreciation inures to charity). Additionally, the annuity is not adjusted to keep pace with inflation and, therefore, may provide significantly less economic benefit to the donor in the later years of the CRAT than in the earlier years. Due to their predictable nature, CRATs are most often used for older clients who are looking for a stable income stream and are unable to tolerate potentially significant fluctuations in income from year to year.

Standard Charitable Remainder Trust

A standard CRUT is a CRT that pays to the non-charitable beneficiary a unitrust amount (i.e., a fixed percentage of the net FMV of the trust assets as revalued annually). The unitrust amount is paid to the non-charitable beneficiary regardless of whether the trust has income for the year and, therefore, as with a CRAT, it may be necessary to distribute principal to satisfy the unitrust amount. Because the unitrust amount is recalculated annually, the unitrust amount fluctuates as the trust's asset value fluctuates. This allows the non-charitable beneficiary to share in asset growth and effectively serves as a built-in inflation adjustment. Because the unitrust amount is based on the value of the trust assets determined annually, annual revaluations of the assets must be obtained, which tends to make CRUTs more expensive to administer than CRATs. If the client anticipates making future contributions to the trust, a CRUT must be used.

Net Income Charitable Remainder Unitrust ("NICRUT")

A NICRUT is a CRUT that pays to the non-charitable beneficiary an amount equal to the lesser of (1) the unitrust amount, or (2) the net income of the trust (determined under §643(b)).

A NICRUT effectively caps the payment to the non-charitable beneficiary at the trust's net income, thereby preventing the trust from having to distribute principal to the non-charitable beneficiary in satisfaction of the unitrust amount. Accordingly, if the trust has no net income for a particular year, the non-charitable beneficiary receives no distribution. NICRUTs should be considered for assets that do not generate significant income, such as vacant land or growth (i.e., non-dividend paying) stock.

Net Income with Make-Up Charitable Remainder Unitrust ("NIMCRUT")

A NIMCRUT is similar to a NICRUT (i.e., it pays to the non-charitable beneficiary the lesser of (1) the

⁴⁹ §170(f)(11)(C).

⁵⁰ See discussion of the taxation of the charitable remainder trust, below.

⁵¹ Income for this purpose refers to fiduciary account income determined under §643(b).

unitrust amount, or (2) the net income of the trust) except that a NIMCRUT (as its name suggests) contains a “make-up” provision that permits income in excess of the unitrust amount to be distributed to the non-charitable beneficiary in certain circumstances.

The make-up provision of a NIMCRUT works as follows:

- For any year in which the net income of the trust is less than the unitrust amount, the non-charitable beneficiary receives the net income.
- The excess of the unitrust amount over the net income for the year (the “make-up amount”) is tracked by the trustees of the trust.
- In any subsequent year in which the net income exceeds the unitrust amount, the non-charitable beneficiary is entitled to receive the unitrust amount and an amount of income equal to the make-up amount.

Example: Assume Donor contributes assets to a NIMCRUT with a \$1,000,000 FMV. The NIMCRUT pays to Donor annually the lesser of a 5% unitrust amount or the net income of the trust. In year 1, the assets of the NIMCRUT generate \$30,000 of income. Because the income (\$30,000) is less than the unitrust amount (\$50,000), Donor receives only a \$30,000 distribution in year 1, resulting in a \$20,000 make-up amount. In year 2, the Trust has \$60,000 of income. Because the unitrust amount is less than the income, Donor receives a distribution of the unitrust amount. However, Donor also is entitled to receive a distribution of income in excess of the unitrust amount up to the make-up amount. Accordingly, Donor is entitled to receive an additional \$10,000 distribution (the remaining income of the trust). The \$10,000 distribution of income reduces Donor’s make-up amount from \$20,000 to \$10,000.

One of the most beneficial aspects of a NIMCRUT is the ability to control the timing of income to the non-charitable beneficiary. The income can be controlled in several ways. First, the trustees can effectively control the timing of income through careful investing and the allocation of income and gains between principal and income. The trustees can invest in non-income-producing assets when the non-charitable beneficiary wants to defer income, and convert the investments into high-income-producing assets when the non-charitable beneficiary wants to receive in-

come.⁵² However, in manipulating investments in this manner, caution must be taken to avoid application of the self-dealing rules.⁵³

In addition to investment decisions, the trustees can manipulate the income of a NIMCRUT by the manner in which they allocate capital gains to income or principal. Generally, capital gains of a CRT may be allocated to income or principal in the trustee’s discretion. However, there are two exceptions to this rule. First, any capital gain from the sale of an asset contributed to the trust must be allocated to principal to the extent of pre-contribution gain.⁵⁴ Second, any capital gain from the sale of an asset purchased by the trust must be allocated to principal to the extent of the purchase price of such asset.⁵⁵

Example: Assume Donor contributes an asset with a \$100 adjusted basis and a \$200 FMV to a NIMCRUT. If the NIMCRUT sells the asset for \$300 there would be \$200 of capital gain. \$100 of this gain would be pre-contribution capital gain that is required to be allocated to principal. The remaining \$100 of capital gain can be allocated to income or principal.

Another, more sophisticated method for manipulating the income of a NIMCRUT is for the NIMCRUT to create a single-member limited liability company (an “LLC”) to hold all of its investments. By wrapping all of its investments in an LLC, the NIMCRUT will have income only if and when the LLC makes distributions to the NIMCRUT. Accordingly, during periods that the non-charitable beneficiary does not want to recognize income, the LLC would simply make no distributions to the NIMCRUT, and during periods that the non-charitable beneficiary wants income, the LLC would make distributions to the NIMCRUT.

Flip-Charitable Remainder Unitrust (“Flip-CRUT”)

A Flip-CRUT is a CRUT that starts out as either a NIMCRUT or NICRUT and then converts or flips into a standard CRUT on a specified date or upon the occurrence of a “triggering event.”⁵⁶ A common triggering event is the trust’s sale or other disposition of an unmarketable asset.

⁵² For example, see TAM 9825001 (purchase of deferred annuity by NIMCRUT does not disqualify trust under §664); PLR 9009047 (same).

⁵³ See discussion on private foundation rules, below.

⁵⁴ Reg. §1.643-3(b).

⁵⁵ *Id.*

⁵⁶ Reg. §1.664-3(a)(1)(i)(c). The triggering event cannot be an event within the control of the settlor, the trustees or any other person. The disposition of unmarketable assets, the marriage, di-

The conversion from a NIMCRUT or a NICRUT to a standard CRUT is deemed to occur on the first day of the taxable year following the year in which the specified date or triggering event occurs.⁵⁷ Upon conversion, any accrued make-up amount (if the CRT started out as a NIMCRUT) is forfeited.⁵⁸ Flip-CRUTs are often used when a donor wants to transfer non-income-producing assets (such as vacant land or growth stock) to a CRT, and, for one reason or another, wants the trust to retain the assets for several years before selling.

Example: Donor owns vacant land that he would like to contribute to a CRT. The vacant land does not generate any income. For various reasons, Donor does not want the vacant land to be sold until four years after the contribution. After the vacant land is sold, the proceeds from the sale will be reinvested in a diversified portfolio. Donor contributes the vacant land to a Flip-CRUT. The Flip-CRUT starts out as a NIMCRUT and Donor retains the lifetime right to the lesser of a 5% unitrust amount and the net income of the trust. In years 1–3, the trust has no net income and, therefore, Donor receives no distribution from the trust. In year 4, the trust sells the vacant land and reinvests the proceeds in a diversified portfolio, which is expected to generate sufficient income to satisfy the unitrust amount. Because CRTs are exempt from taxation, no gain is recognized on the sale of the vacant land. Because the vacant land was sold in year 4, the conversion of the trust from a NIMCRUT to a standard CRUT is deemed to occur on the first day of year 5. Accordingly, beginning in year 5, Donor will be entitled to a 5% unitrust amount, irrespective of trust income. Any make-up amount from years 1–4 is forfeited upon conversion.

TAXATION OF CRTs AND CRT BENEFICIARIES

Taxation of the Charitable Remainder Trust

As discussed above, CRTs are exempt from federal and state income tax and the 3.8% NIIT. However, a

voice or death of an individual and the birth of a child by an individual are all examples of permissible triggering events. *See* Reg. §1.664-3(a)(1)(i)(c)(1).

⁵⁷ Reg. §1.664-3(a)(1)(i)(c)(2).

⁵⁸ Reg. §1.664-3(a)(1)(i)(c)(3). After the conversion, the trust will be a standard CRUT, which does not permit distributions to the non-charitable beneficiary other than the unitrust amount.

100% excise tax is imposed on any unrelated business taxable income (“UBTI”) of the CRT.⁵⁹ UBTI is determined under §512 and includes items of income such as debt-financed income and taxable income derived from investments in trade or business activities held in pass-through entities. A full discussion of what constitutes UBTI is beyond the scope of this Article; however, practitioners should familiarize themselves with these rules. The 100% excise tax effectively requires the CRT to forfeit all of its UBTI; however, the existence of UBTI does not otherwise affect the tax-exempt status of the CRT.

Taxation of Charitable Remainder Trust Beneficiaries

Income and Gains Generally

Although income and gains are not taxed to the CRT itself, distributions from the CRT carry out income and gains of the CRT to the non-charitable beneficiary based on a four-tier system that determines the character of the distribution based on the character of the income and gains of the CRT.⁶⁰

Under the four-tier system, the character and taxation of distributions are determined as follows:

- First, trust income is assigned to one of three classes of income (ordinary income, capital gains or other income, such as tax-exempt income).
- Second, items within a particular class of income are further divided based on the tax rate that applies to the various income items within the class. For example, if the income items assigned to the ordinary income class consist of interest income, which is subject to a maximum tax rate of 39.6% and qualified dividend income, which is subject to a maximum tax rate of 20%, these items would be assigned to separate subclasses.
- Third, once the income has been assigned to its appropriate class, the character of the distribution to the non-charitable beneficiary is determined by treating the distribution as being made from the various classes of income in the following order:
 - Ordinary Income (to the extent thereof);
 - Capital Gains (to the extent thereof);
 - Tax Exempt Income (to the extent thereof); and

⁵⁹ §664(c)(2).

⁶⁰ §664(b); Reg. §1.664-1(d).

- Tax-free return of principal.
- If there are subclasses of income within a particular class of income (e.g., within the ordinary income class — interest subject to a maximum rate of 39.6% and qualified dividends subject to a maximum rate of 20%), the subclass subject to the highest maximum tax rate is deemed to be distributed first.

Example: Donor creates a CRUT which pays to Donor a 5% unitrust amount annually. In year 1, the value of the trust assets for purposes of determining the unitrust amount is \$1,000,000 and, therefore, Donor will receive a \$50,000 distribution. In year 1, the CRT has \$65,000 of income, which consists of \$25,000 of interest income (subject to a maximum 39.6% tax rate), \$15,000 of rental income (subject to a maximum 39.6% tax rate), \$15,000 of qualified dividends (subject to a maximum 20% tax rate) and \$10,000 of capital gains (subject to a maximum 20% tax rate). The \$50,000 unitrust amount distributed to Donor will be treated as consisting of \$25,000 of interest income, \$15,000 of rental income and \$10,000 of qualified dividend income.

Any income that is not deemed to be distributed to the non-charitable beneficiary in the current year maintains its character for purposes of determining the character of distributions in subsequent years.

Net Investment Income

As noted above, a CRT itself is not subject to the 3.8% NIIT. However, distributions to the non-charitable beneficiary of the annuity or unitrust amount may carry out the NII to the non-charitable beneficiary.⁶¹ Generally, distributions from a CRT carry out NII to the non-charitable beneficiary under the same four-tier system discussed above. For purposes of assigning items of NII to a subclass of income within a particular class of income, the 3.8% tax on NII is tacked on to the tax rate otherwise applicable to each item of income that constitutes NII.⁶² Distributions to the non-charitable beneficiary are then characterized in the manner discussed above.

For example, income from an individual retirement account (an “IRA”) and interest income would both

be assigned to the ordinary income class. However, because the interest income is NII and the IRA income is excluded from NII, the combined tax rate applicable to the interest income would be 43.4% (39.6% plus 3.8%) and the combined tax rate applicable to the IRA income would be 39.6%. Thus, under the four-tier system, the interest income would be deemed to pass to the non-charitable beneficiary before the IRA income. It is not always the case, however, that NII will be deemed to be distribution prior to income that is not NII. For example, if a CRT has IRA income, which is not NII, and qualified dividend income, which is NII, the IRA income would be subject to a maximum aggregate tax rate of 39.6% and the qualified dividend income would be subject to a maximum aggregate tax rate of 23.8% (20% plus 3.8%). Accordingly, under the four-tier system, the IRA income would be deemed to be distributed to the non-charitable beneficiary prior to the qualified dividend income.

It may be possible to avoid payment of the 3.8% tax on NII in its entirety. For example, if an item of income that constitutes NII is deemed to be distributed out to a non-charitable beneficiary, such item of income is only subject to the 3.8% tax on NII if the non-charitable beneficiary to whom it is distributed has AGI for the taxable year of the distribution in excess of the threshold necessary to trigger the tax (i.e., AGI in excess of \$200,000 for an individual and \$250,000 if married and file jointly).⁶³

PRIVATE FOUNDATION RULES

Although a full discussion of the private foundation rules is beyond the scope of this Article, it should be noted that CRTs are subject to some of the same rules that apply to private foundations, the most commonly applicable of which is the self-dealing rules.⁶⁴ These rules strictly prohibit most transactions between the CRT and the settlor, any substantial contributor to the CRT, or any individual or entity deemed related to one of the foregoing.⁶⁵ For further discussion of the self-dealing and other private foundation rules applicable to CRTs, see 865 T.M., *Charitable Remainder Trusts and Pooled Income Funds*.

CONCLUSION

For any client who is charitably inclined and is looking for a way to reduce his current income tax li-

⁶¹ Reg. §1.1411-3(d).

⁶² Reg. §1.1411-3(d)(2). Income accumulated prior to Jan. 1, 2013 (“pre-2013 income”) is excluded from NII. Accordingly, the 3.8% tax on NII will not be tacked on to pre-2013 income when assigning the income items to a subclass of income within a particular class of income, even if such income would otherwise qualify as NII. See Reg. §1.1411-3(d)(1)(iii).

⁶³ See §1411.

⁶⁴ Reg. §1.664-1(b).

⁶⁵ §4947(a)(2). Transactions that constitute self-dealing may include (without limitation) purchases, sales, leases, loans, excess compensation and use of trust property. §4941(d)(1).

ability while also reducing future estate tax, an inter vivos CRT may prove to be just what the doctor ordered. Additionally, while a testamentary CRT does not offer an income tax deduction, it allows a charitably inclined client to receive an estate tax charitable deduction while still providing an income stream for

non-charitable objects of the client's bounty. In order for the full benefits of a CRT to be realized, practitioners must have a working knowledge of the rules applicable to CRTs and an understanding of when the various types of CRTs are best utilized.