Charitable Remainder Trusts: Types and Traps

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Take-Away: Charitable remainder trusts (CRTs) are a great way to save income taxes and to support a donor's favorite charity. However, like any estate planning strategy, there are also traps along the way to be mindful of when funding a CRT.

Background: CRTs are often used to avoid capital gains taxes when the appreciated donated asset is sold by the CRT. The CRT, if *qualified,* is technically a tax-exempt *charity,* which means the charity does not pay a capital gain tax when it sells the appreciated asset. If the CRT donor is an income tax itemizer, he/she can deduct the value of the CRT's remainder interest using IRC 7520 and the IRS's life expectancy tables. There are, though, the various percentage of adjusted gross income ceiling limits that the donor faces when he/she claims the federal charitable income tax deduction; still, any unused charitable deductions caused by those AGI limitations can be carried over by the donor for the next 5 calendar years. [IRC 170(f)(2).]

Income Tax Rules: The income tax consequences of distributions from a CRT to its beneficiary (usually the donor) are a bit more complicated.

> Worst-In, First-Out Rule: The payments made to the CRT beneficiary are taxable under a four-tier category system of reporting. [IRC 664(b).] The first dollars paid out to the CRT beneficiary are taxed as ordinary income. Next paid out to the CRT beneficiary are capital gains. Next is 'other income', e.g., tax-exempt income. Finally, what is paid out to the CRT beneficiary is CRT corpus (non-taxable.) The income paid to the CRT beneficiary retains the character that it had in the CRT. What is critical, however, is that each distribution is treated as from that priority until the CRT is 'emptied' of that class or tier of income. Accordingly, distributions will be treated as ordinary income to the extent of the CRT's ordinary income for the calendar year, and any undistributed ordinary income from

prior years, is paid out first, before moving to the next category of income, e.g. capital gains. This is called the *worst-in, first-out rule.*

Tax Implications to the CRT Beneficiary: A couple of 'take-aways' from the *worst-in, first-out* rule are: (i) seldom will a CRT be funded with retirement assets like an IRA, since almost all retirement assets are taxed as ordinary income, so that it will take multiple years (or decades!) before the CRT ever makes a capital gain distribution to its beneficiary; and (ii) using the CRT to sell appreciated assets does not avoid the payment of the capital gain by the CRT beneficiary, it just delays the recognition of that capital gain as income by the beneficiary over the beneficiary's lifetime- in sum, the gain recognition is delayed and spread over the CRT beneficiary's lifetime and not paid 'up front' as if the beneficiary had sold the appreciated asset directly and not through the CRT. Thus, more assets remain in the CRT generating income for the donor over the donor's life expectancy.

Exception: There is one exception to this ability to spread of the capital gain recognition over the CRT beneficiary's lifetime. The gain will be immediately taxable to the CRT donor if the contributed asset is sold and the sales proceeds are invested by the CRT trustee in tax-exempt securities, pursuant to an express or implied agreement between the donor and the CRT trustee. [Revenue Ruling 60-370.]

UBTI: A CRT with unrelated business taxable income (UBTI) remains tax-exempt from federal income tax. However, the UBIT will be subject to a 100% excise tax.

Tax Exempt Income: CRT trustee's investment or reinvestment in tax-free bonds will not disqualify the trust as a CRT and it will not affect the CRT's tax exempt status from income taxation. [IRC 664(c).] However, the can be no express or implied agreement that the CRT trustee must invest in those bonds. [Private Letter Ruling 7803041, October 20, 1977.] This can present a problem since many CRT trustees are the donor, so it is much

easier for the IRS to claim a 'prearrangement' when the donor-CRT trustee invests in tax-free investments.

Types of CRTs: There are several types of charitable remainder trusts (CRTs) to choose from, each with its own unique characteristic and planning opportunities.

Basic Formation Requirements: All CRTs have some basic formation requirements to constitute a *qualified* charitable remainder trust with its tax-exempt feature.

CRATs: A charitable remainder annuity trust (CRAT) must pay the beneficiary a fixed dollar amount (i.e., an annuity) annually, as identified in the CRAT instrument. On the death of the CRAT beneficiary or the surviving beneficiary, or at the end of the CRAT's selected fixed term, which cannot exceed 20 years, the charity must receive the remaining CRAT assets. The fixed dollar amount paid from the CRAT must be at least 5% but not more than 50% of the initial net fair market value (FMV) of the assets transferred to the CRAT. In addition, the charity's remainder interest in the CRAT must be at least 10% of the initial net FMV of all property that is transferred to the CRAT. No additional contributions can be made to the CRAT after the initial transfer of assets to it. Finally, unlike a charitable remainder unitrust (CRUT) described below, the CRAT must also satisfy an initial 5% probability 'test' that assures that the CRAT that makes annuity payments to one (or more) of its non-charitable beneficiaries' lifetimes, must have less than a 5% chance of the CRAT corpus being exhausted. As a generalization, CRATs are normally used by older beneficiaries since a CRAT does not provide a hedge against inflation with its fixed annuity amount, and the younger the CRAT beneficiary, the harder it will be to satisfy the 5% probability 'test.' Yet, as interest rates continue to rise, it may be easier for a CRAT to satisfy its 5% probability test, which means that that a CRAT might still work for some younger CRAT beneficiaries with longer life expectancies.

CRUTs: A CRUT pays the CRUT beneficiary an amount that is determined by multiplying a fixed percentage of the net FMV of the CRUT assets, revalued each year (a unitrust payment.) Like the CRAT, the CRUT term is either the death of its beneficiary(or a survivor beneficiary), or at the end of the CRUT fixed term if the CRUT duration is measured by a term of years, not to exceed 20 years. Again, the fixed percentage amount cannot be less than 5% or greater than 50% of the amount contributed to the CRUT, and the charity's remainder interest must be at least 10% of the initial FMV of all property that is transferred to the CRUT. Unlike a CRAT, additional assets can be added to the CRUT in later years. A CRUT provides a better hedge against inflation than a CRAT, since the unitrust amount is applied to an potentially increase in the CRUT's current asset values. Nor is there is an initial 5% probability test to satisfy with a CRUT. Finally, unlike a CRAT, there are a variety of CRUTs to choose from.

- STAN-CRUT: The standard CRUT, or STAN-CRUT, is simply a Trust that pays the fixed percentage (unitrust) amount of the CRUT's assets each year to its beneficiary. Then, there are a variety of options to the standard CRUT.
- NIM-CRUT- This CRUT pays only the trust income if the actual income is less than the stated percentage multiplied by the CRUT asset's annual FMV. Deficiencies in distributions when unitrust income is less than the stated percentage are made-up in later years, if (when) the trust income exceeds the CRUT's stated percentage amount. This type of trust is sometimes used as a retirement income supplement, where non-income producing assets, e.g., raw land, is placed in the CRUT and left to appreciate until the donor retires and the land is then sold by the CRUT trustee.
- Ni-CRUT- This CRUT pays the fixed percentage multiplied by the CRUT's FMV or the trust's actual income, whichever is lower. Deficiencies are not made-up in later years.
- FLIP-CRUT- This CRUT is either a NIM-CRUT or a Ni-CRUT, but on a qualifying trigger event that is specified in the trust instrument, e.g. the sale of unmarketable assets used to fund the CRUT, it switches or

flips to a standard CRUT which pays the unitrust amount to the CRUT beneficiary.

- FLEX-CRUT- This CRUT is either a NIM-CRUT or a Ni-CRUT that flips to a standard CRUT on the sale of a parcel of real estate or on an a specified date or event identified in the trust instrument. To maximize the flexibility of this type of CRUT, often specified in the trust instrument is the sale of an unimportant unmarketable asset but is one of the assets that is used to initially fund the CRUT. By identifying that 'unimportant' asset the CRUT trustee retains the flexibility to determine when, if ever, a NIM-CRUT or a Ni-CRUT will flip/convert to a standard CRUT.
- Capital Gains-CRUT: This CRUT specifies that the capital gains attributable to appreciation subsequent to the assets' transfers to the CRUT can be treated as income for purposes of paying income to the CRUT's income beneficiary. This intentional treatment of capital gains as trust income provides another way to make up NIM-CRUT deficits in payments from earlier years.

CRT 'Traps:' Some things to keep in mind when creating a CRT follow in light of several IRS private letter rulings:

> Pre-arrangement: As noted earlier, a CRT that is funded with appreciated property that is to be sold and the proceeds invested in tax-exempt securities can result in double taxation. If the CRT trustee is under an express or implied obligation to sell or exchange the transferred appreciated property and purchase tax-exempt securities, the CRT's donor is deemed to have sold the property and given the CRT trustee the sales proceeds. The capital gain from the sale is imputed to the donor and thus includible in the donor's gross income. Note, too, that the donor will have to pay that capital gains tax out of the donor's own investment portfolio and not from the CRT's assets. This becomes a serious problem when the donor also serves as CRT trustee. [Revenue Ruling 60-370.]

Multiple Donors: The IRS takes the position that a CRUT with more than one donor is not a *qualified* CRT. [Private Letter Ruling 9547004, November 24, 1995.] This position does not apply when spouses are the CRT donors, but it applies to multiple non-spouse donors. [Revenue Procedure 2003-53.]

Undivided Property Interests: If a partial interest in an asset is contributed to the CRT, and the remaining partial interest is retained by the donor, e.g., a fractional interest in commercial real estate is the subject of the donation to the CRT, the IRS takes the position that the transfer to the CRT results in *deemed self-dealing*, which disqualifies the CRT as a tax-exempt entity. [Private Letter Ruling 9114925, April 5, 1991.]

Mortgaged Property: If a CRT is funded with mortgaged property and the donor remains personally liable on the mortgage, the IRS takes the position that the mortgage violates the rule that the CRT must function *exclusively* as one that is tax-exempt from the date of CRT's creation. [Private Letter Ruling 9015049, April 13, 1990.] Apparently if the mortgaged property transferred to the CRT is non-recourse to the donor, then that mortgage will not pose a problem to the CRT's tax-exempt status.

Tangible Personal Property: Contributing tangible personal property to the CRT can raise a 'red flag' with the IRS. In one Private Letter Ruling the IRS denied the donor's charitable income tax deduction when the donor contributed a violin to the CRT because the donor retained an income interest in the violin. However, when the CRT sells the violin a tax deduction would then be available, although limited to the remainder value of the income tax basis in the violin because of the 'unrelated use' of that tangible personal property (the violin) to the CRT tax exempt charity. [Private Letter Ruling 9452026, December 30, 1994.]

Commutation of CRT: Some donors have second-thoughts after they create their CRT. The donor then approaches the charity and suggests that they terminate the CRT with the donor receiving the CRT assets equal to

the then-value of the donor's unitrust/annuity interest and the charity receiving CRT assets equal to the then-value of its CRT remainder interest. The IRS will claim that the donor realizes capital gains equal to the value of the donor's remaining interest in the CRT. The money or assets received by the donor on the CRT's termination will not represent the donor's annual unitrust amount, so that the taxable four tier tax categories will not apply. Rather, the donor will be treated as disposing of the donor's CRT interest in an exchange for money and property, and the transaction will be governed by IRC 1001. The sale of an income interest in a trust is a sale of a capital asset [IRC 1221 and 1222] governed by the seller's 'holding period' in the trust to determine whether gain or loss from the disposition of that income interest is long term or short term commences on the date the donor first held his/her interest, but the donor will be treated by the IRS as having no tax basis in their 'sold' income interest. [Private Letter Ruling 200127023, July 6, 2001.]

Conclusion: Estate planning with the use of a CRT can be highly effective to create a federal income tax charitable deduction and also remove appreciating assets from the donor's taxable estate. But like any split-interest trust, there are plenty or rules to follow and several tax 'traps' along the way to avoid. It is probably wise to not stray too far from the model CRAT and CRUT instruments that the IRS has created, something close to 'safe harbors' to avoid most of the tax-traps that are identified above. [See Revenue Procedures 2003-53 through 60 and Revenue Procedures 2005-52 through 59.]