# WHAT IS A CHARITABLE REMAINDER TRUST?

Introduction to Charitable Remainder Trusts (CRT)

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A Charitable Remainder Trust ("CRT") is usually created by a person (the "Grantor") for his/her own benefit, and provides for an "income interest" to be paid to the Grantor for the remainder of his/her lifetime. Upon the death of the Grantor, the remaining assets in the CRT are distributed to a designated charity. The Grantor can reserve the right to change the charity at any time during the Grantor's lifetime.

The "income interest" payable to the Grantor is either (i) a fixed dollar amount per year, or (ii) an amount based on a fixed percentage of the assets of the CRT as redetermined each year.

A CRT which provides for a fixed dollar amount is known as a Charitable Remainder Annuity Trust ("CRAT"). A CRAT has the advantage of a guaranteed payment, regardless of the actual rate of return realized on the investment of the trust assets. However, the Grantor will not benefit from any increase in value of the trust assets during the Grantor's lifetime.

A CRT which provides for a payment based on a fixed percentage of the asset value is known as a Charitable Remainder Unitrust ("CRUT"). The assets of the CRUT are valued each year to determine the payments to be made to the Grantor for that year.

Under an alternate version of the CRUT, the payment to the Grantor will be the lesser of the net income or the fixed percentage amount. Such a CRUT can (and usually does) provide that if the payment to the Grantor for any year is less than the fixed percentage amount because the actual income is less, this undistributed amount will be paid to the Grantor in any later year if the actual net income of the trust for such later year is greater than the fixed percentage amount. This type of CRUT is known as a Net Income With Makeup CRUT (also called a "NIMCRUT").

As a result of Regulations issued by the IRS, there is another alternative which is also available. This CRT is often referred to as a "FLIP Unitrust," and starts out as a NIMCRUT (usually because the trust holds an asset which is to be sold and does not currently generate much, if any, income), then converts to a standard Unitrust at some future date or event (such as the sale of the asset).

### Income Tax Consequences of a CRT

The following tax benefits are available for any CRT which qualifies under the provisions of the Internal Revenue Code. In order to qualify, one significant requirement is that the present value of the remainder interest (determined at the time the trust is created or when assets are added to the trust) must be at least 10% of the value of the CRT assets. In addition, the payment to the non-charitable beneficiary cannot be less than 5% nor more than 50% of the trust assets as determined each year (although a 50% distribution would almost always violate the 10% minimum charitable value rule anyway).

**Income tax deduction.** Upon the creation of a CRT, the Grantor is making a gift of a remainder interest to charity with respect to the assets transferred to the CRT. The Grantor is permitted to take a current income tax deduction equal to the present value of such remainder interest. The deduction is determined by valuation tables provided by the IRS, based on (i) the age of the Grantor when the CRT is created, and (ii) the discount interest rate currently allowed for determining such values (this rate changes each month, but the Grantor is permitted to use the rate for the current month or either of the two months prior to the creation of the CRT).

As with all charitable income tax deductions, there may be a limit on the amount which can be claimed for a particular year, based on the total gross income of the Grantor for such year and the type of asset contributed. Usually, any amount which cannot be used in the year the CRT is created may be used (subject to the same annual limitations) in any of the next five taxable years.

**CRT as a tax-exempt entity.** A CRT is a tax-exempt entity for income tax purposes. Therefore, if a CRT sells an appreciated asset, there is no capital gain reportable by the CRT. In addition, the CRT is not taxed on any other type of income generated within the CRT. This is one of the most significant tax advantages of a CRT.

For example, if a person has an asset currently worth $1,000,000, and the person originally paid $100,000 to acquire the asset, the asset has appreciation of $900,000. If the person sells the asset, the person will have capital gain of $900,000 and, at a capital gain tax rate of 25% (federal and state), will pay $225,000 in income taxes, leaving only $775,000 to be reinvested. If the same person transfers the asset to a CRT and the Trustee of the CRT sells the asset, no capital gain is recognized, and the full $1,000,000 can be reinvested for the person's benefit.

It is important that the appreciated asset not be "sold" prior to the date it is transferred to the CRT, with the Trustee of the CRT simply carrying out the terms of the sale. In order to realize the tax benefits described above, the Trustee of the CRT must be free to sell or retain the appreciated asset after it is transferred to the CRT by the Grantor.

**Taxation of Distributions to Grantor.** Although the transactions within a CRT are not subject to income tax, any distribution to the Grantor will be taxable to the extent it represents taxable income generated within the CRT. In determining the taxability of distributions to the Grantor, each distribution is characterized based on the following priority:

- First, the distribution is treated as ordinary income (such as interest and dividends) to the extent the CRT has ordinary income for the current year, or undistributed ordinary income from prior years.
- Second, the distribution is treated as capital gain to the extent the CRT has any capital gain for the current year, or undistributed capital gain from prior years.
- Third, as other income (which includes any tax-exempt income such as municipal bond interest).
- Fourth, as principal.

This priority system is important with respect to any capital gain which is not recognized by the CRT at the time an appreciated asset is sold. Such capital gain may later be recognized by the Grantor when subsequent distributions are made to the Grantor from the CRT. Even if the CRT invests the sale proceeds only in assets which generate tax-exempt interest income, the subsequent distributions to the Grantor each year will be taxable until all of the previously unused capital gain has been distributed. However, if the CRT has current income (other than tax-exempt income) which is equal to or greater than the annual distribution to the Grantor, the prior capital gain will not be recognized.

## Estate Tax Consequences of CRT

Because the assets of the CRT pass to charity at the death of the Grantor, there will be no estate tax paid on the assets of the CRT at the Grantor's death. Therefore, the estate tax benefit is the same as if the Grantor makes a bequest to charity in his/her Will (or Revocable Trust).

## Tax Consequences if Another Beneficiary is Named

If anyone other than the Grantor or the Grantor's spouse is the "income" beneficiary of the CRT, there can be gift and/or estate tax consequences upon the creation of the CRT (or upon the death of the Grantor, if the "income" interest continues for the other beneficiary). For example, if the CRT is originally created for the benefit of the Grantor's children (or other family members), the Grantor is making a taxable gift at the time the CRT is created, basically equal to the present value of the payments to be made to the non-charitable beneficiaries during the existence of the CRT.

## Impact on Family

Because the assets of the CRT will pass to charity upon the Grantor's death, the assets will not be available for the benefit of the Grantor's family. Because of this, a CRT is most beneficial to a Grantor who otherwise wants some or all of his/her estate to pass to charity at his/her death. However, even for a Grantor who desires his/her estate to pass to family members at death, a CRT may be a useful technique if the Grantor wants to benefit both family and charity. The CRT should probably not be considered by anyone who has no interest in providing a benefit to charity.

Remember that, if a CRT is created, the assets passing to the Grantor's family are not being reduced by the full value of the asset transferred to the CRT, but only by the value which would pass to the family after the estate tax is imposed at the Grantor's death.

**Benefit of income tax deduction.** The immediate income tax deduction available to the Grantor of a CRT may mean that the Grantor will have more assets at death to pass to family members (because the estate is not depleted by the income taxes which are saved).

**Benefit of avoiding capital gain.** Because the CRT avoids (or at least postpones) the capital gain tax on the sale of an appreciated asset, the entire proceeds from the sale will be reinvested for the Grantor's benefit. Therefore, the annual distributions to the Grantor from a CRT are usually higher than the amounts which would otherwise be realized if the appreciated asset was simply sold, and the Grantor invested the proceeds reduced by the income tax on the capital gain. To the extent the Grantor does not consume this excess cash flow, the additional amount will increase the estate which will eventually pass to the Grantor's family.

**Using life insurance to replace value to family.** The Grantor may acquire a life insurance policy which will provide a death benefit to the family equal to (or even greater than) what the family would have received at the Grantor's death if the CRT was not created. The best way to acquire such a policy would be for (i) the family members to own the policy or (ii) the policy to be purchased through an irrevocable insurance trust (so that the policy proceeds would not themselves be subject to estate tax at the Grantor's death).

The Grantor can pay for part or all of the insurance premiums with (i) the income tax savings caused by the creation of the CRT, and (ii) the increased cash flow available to the Grantor following the sale and reinvestment of an appreciated asset within the CRT.

## Self-Dealing Rules

When creating a CRT, it is important to remember that most transactions between the CRT and "disqualified persons" are prohibited by federal tax law. A disqualified person is the Grantor of the CRT and the Grantor's immediate family members (and entities owned by such persons). For example, a disqualified person would not be allowed to sell assets to or purchase assets from the CRT, and a disqualified person may not rent the assets of the CRT (such as real property). Specifically, the Grantor of the CRT and any family member may not continue to live in any residential property held in the CRT, regardless of whether or not fair market rent is paid for the use of the property.