

# PROFESSIONAL TAX & ESTATE PLANNING NOTES

March 2008

## Charitable Remainder Trusts

Charitable remainder trusts (CRTs) provide for the eventual transfer of property to charity after paying income to one or more non-charitable beneficiaries. The New York Community Trust is an ideal remainderman of a CRT because of its flexibility and experience.

### Benefits of Qualified Charitable Remainder Trusts

CRTs are extremely useful estate and financial planning tools for many individuals and businesses. Typically, they offer three important tax benefits:

- a current income tax deduction for the present value of the remainder committed to charity;
- the avoidance of capital gains tax when the appreciated assets are sold;
- exemption from tax of earnings of the trust until they are distributed to the income beneficiary.

A trust qualifies for these benefits only if it meets the strict requirements of Code Section 664 and related Treasury regulations\*.

A person who creates a charitable remainder trust usually is entitled to an income and gift tax deduction at the time the trust is created (or an estate tax deduction if the trust is created at death) equal to the value, determined under Treasury Department tables, of the remainder committed to charity. Several factors determine the amount of the deduction, including the value of the property contributed to the trust, the length of

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\*All "Code" references are to Sections of the Internal Revenue Code of 1986, as amended, and all "Treasury Regulation Section" references are to regulations thereunder.

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time the trust is expected to make payments to non-charitable beneficiaries, and the size of the annual payment. Usually, the longer the trust is expected to last and the higher the annual payments, the smaller the deduction.

As a general rule, CRTs are exempt from income tax. To the extent the trust earns income (including capital gain) in excess of the amounts currently payable to the non-charitable beneficiaries, a tax-free or tax-deferred accumulation of income occurs. Before 2007, even \$1 of unrelated business taxable income (UBTI) would result in all the CRT's income in that year being subject to tax. In an important development, Code Section 664(c) was amended in 2006 so that a CRT with UBTI instead is subject to an excise tax equal to 100 percent of the UBTI.

A CRT makes annual payments in the form of either (1) an annuity (a charitable remainder annuity trust or CRAT) or (2) a unitrust amount (a charitable remainder unitrust or CRUT). The various types of CRUTs and the special rules that govern them will be discussed in the next issue of *Professional Notes*.

## Requirements

Annual payments from a CRAT are fixed as either a stated dollar amount or a fixed percentage of the initial trust value. Annuity trusts are particularly appropriate for income beneficiaries who—because of age or the availability of other assets—are not worried about inflation reducing the spending power of the annuity distribution.

The term of a charitable remainder trust (for both CRATs and CRUTs) must be measured by the lifetime of the beneficiary, or for a term not to exceed 20 years. The trust instrument may name one or more charities to receive the trust remainder.

Annuity trusts are particularly appropriate for income beneficiaries who—because of age or the availability of other assets—are not worried about inflation reducing the spending power of the annuity distribution.

The payout rate of a CRAT must be at least five percent of the initial trust corpus, and may not exceed 50 percent. Additions to trust principal are not permitted. The law also requires that there may not be a more than five percent probability that the trust assets will be exhausted before the trust terminates.

In addition, the value of the charitable remainder must be at least 10 percent of the fair market value of the assets, which is measured when the CRT is created. Some taxpayers may inadvertently run afoul of the 10 percent rule, particularly where the CRT is to be established at death, because the life expectancy of the income beneficiary is an unknown until that time. The statute permits a trust to be reformed to comply with this requirement, and the draftsman will want to consider giving the trustee the power to decide whether to amend the trust or to declare the trust void.

The Internal Revenue Service has published model forms of CRATs, both *inter vivos* and testamentary, in Revenue Procedures 2003-53 – 2003-60.

It is important that the CRT meet the statutory requirements from inception to final distribution. In *Estate of Atkinson v. Commissioner*, 309 F. 3d 1290 (11th Cir. 2002), *aff'g* 115 T.C. 26 (2000), the estate was denied a charitable deduction for assets transferred to a purported CRAT that failed to make distributions to the income beneficiary.

## Other Considerations

If the CRT is created during the grantor's lifetime, the transferred income interest may be subject to gift tax. In addition, if the donor of an *inter vivos* charitable remainder trust reserves the life interest for himself, the trust corpus will be included in his gross estate, although the value of the remainder interest is deductible to the estate.

Under New York law, as in a number of other states, a surviving spouse has the choice of receiving that part of the estate passing to him or her by will and other testamentary provisions or renouncing this interest and claiming his or her elective share. The base against which the elective share may be claimed includes property transferred by the decedent in which he or she retained some interest. A transfer to a charitable remainder trust in which the decedent retained a lifetime income interest is included in this base.

As a result, it is possible that a gift to charity through a charitable remainder trust in which the decedent retained an interest would be reduced to contribute to the spousal election. Because no amount other than the annuity or unitrust amount or the charitable distribution may be paid from the trust, there is a risk that the CRT will not qualify because it is not exclusively for a charitable remainderman from its inception. As a result, not only would the charitable income tax deduction be denied, but the remainder trust would not be tax exempt and would not qualify for estate and gift tax benefits.

*Example:* Mr. Jones contributes low basis, highly appreciated stock to a charitable remainder trust in January 2005. He and his wife, or the survivor of them, will receive a 6 percent annuity each year, and at their deaths the remainder is to go to a fund in The New York Community Trust for a particular passion of theirs, parks and open spaces. Unfortunately, following Mr. Jones's death later that year, Mrs. Jones exercises her right of election. The gift to The New York Community Trust is included in the computation of the elective share and one-third of the gift must be returned to the estate and to Mrs. Jones. As a result, no charitable deduction is permitted, because the trust is no longer a qualified split interest trust. The trust is taxed on the capital gains realized when the stock is sold, and on future income and gains from

investments. In addition, the gift will not qualify for the estate tax charitable deduction. In such event, the value of the transfer to charity, if worth more than \$12,000, would be subject to gift tax.

In Rev. Proc. 2005-24, the IRS reached just this conclusion, advising that the mere existence of a spousal right of election, whether or not exercised, would cause a CRT created during the donor's lifetime to fail to qualify under IRC Section 664(d). The ruling set out a safe harbor under which the IRS would disregard a right of election with respect to an *inter vivos* CRT. CRTs created before June 28, 2005 were grandfathered.

In that ruling, which has since been suspended pending further guidance, the IRS advised that the surviving spouse must irrevocably waive the right of election in writing, and that the waiver must be executed not later than six months after the due date for Form 5227 for the CRT (without extensions) in the later of the year (i) in which the CRT is created, (ii) of the marriage of the grantor to the non-grantor spouse, (iii) in which the grantor becomes domiciled or resident in a state with a right of election that could be satisfied with CRT assets, or (iv) of the effective date of applicable state law creating a right of election.

A number of concerns were raised about the undue burden of the revenue procedure, and on February 3, 2006, the IRS issued Notice 2006-15 confirming that it is rethinking the approach taken in the earlier revenue procedure and extending indefinitely the June 28, 2005 grandfather date. For now, as long as the spouse does not in fact exercise the right of election as to CRT assets, the mere possibility of such an exercise will not disqualify the CRT.

To avoid unintended consequences to estate plans, a non-contributing spouse should waive a right of election as to a charitable remainder trust at the time the trust is created. If a waiver was not obtained at

the time the trust was established, consider a late waiver as a reformation of the original charitable remainder trust.

### Taxation of Distributions

Income beneficiaries will be subject to tax on distributions from a CRT. The distributions are characterized for tax purposes by reference to the income of the trust from inception using a tier system that takes into account the different rates of tax on various types of income and capital gains. Distributions are taxed:

- first, as ordinary income to the extent of the trust's current and accumulated undistributed ordinary income. For this purpose, if the trust has different classes of ordinary income, distributions are deemed to begin with the class with the highest tax rate and end with the lowest rate;
- second, as capital gain, to the extent of current and past capital gains;
- third, as tax-exempt income, to the extent of current and past tax-exempt trust income;
- last, as a return of capital.

Under regulations adopted in 2005, capital gains and losses are assigned to different classes based on the Federal income tax rate applicable to that type of asset as of the end of the year the items are required to be taken into account by the CRT. The regulations are complex on how gains and losses are to be netted, and provide that capital gains and losses of each class are netted first against each other; then, net long-term capital losses of the class subject to the highest tax rate are offset against net gains of other long-term capital classes, beginning with the class with the highest rate; and finally, to offset any net short-term capital gain. Similarly, net short-term capital loss is used to offset any net gain from each class of long-term capital gain and loss, beginning with the class subject to the highest rate. A given class of capital gains is taxed to the beneficiary at the rate applicable to that class in the year it is deemed *distributed*.

### Funding the CRT

Certain kinds of assets work better than others for funding a CRT. The following assets are particularly appropriate contributions to CRTs:

***Appreciated assets.*** Highly appreciated assets, such as stock or real estate, may be contributed to the CRT and sold by the trustee, with the proceeds reinvested. Because the CRT is not subject to tax, the gain on the sale by the trust of these assets will be free from tax. As a word of caution, the IRS has, in certain circumstances, imputed the gain directly to the grantor, when, for example, there was an understanding with the trustee that the contributed assets would be sold.

***Gifts of Stock of Closely Held Companies.*** Like publicly traded stock, closely held stock can be a wise funding source for a CRT if the stock has been held for more than one year. However, because gifts to a private foundation of closely held stock are deductible only in the amount of the donor's basis, the charitable beneficiary of the CRT should be restricted to a public charity. Gifts to a public charity of stock of closely held companies that has been held for more than one year are deductible at fair market value.

Although charities may hold S corporation stock, a charitable remainder trust is not an eligible stockholder, and the transfer of S corporation stock to a CRT will terminate the corporation's S status. Forfeiting its S status means the corporation will be taxable as a regular "C" corporation. An alternative worth considering might be to have the S corporation create the CRT with appreciated assets. The charitable deduction would pass through to the shareholders of the S corporation.

***Retirement assets.*** Because retirement plan assets constitute income in respect of a decedent, these assets can be subject to both income and estate taxes at death. By contributing assets such as IRAs to a charitable remainder trust at death, the income tax and estate taxes can

be avoided, and individuals other than a spouse may benefit from the retirement plan assets.

**Tangible personal property.** Valuable personal property may be a smart choice for funding a CRT. However, it is important to note that Code Section 170(a)(3) provides that a charitable contribution of a future interest in tangible personal property is considered to be made only when all intervening interests in the property have expired or are held by persons other than the donor. The IRS has ruled that a donor who contributed a violin to a CRT of which he was the income beneficiary had retained an interest in the violin. As a result, the charitable deduction was permitted only when the trustee sold the instrument. Moreover, the charitable deduction for gifts of tangible personal property to a CRT is limited to the property's basis.

### Selecting the Charitable Remainderman

Regardless of how long the CRT is slated to last, eventually the property in the trust must pass to charity. The grantor of a CRT may name a charity at the time the trust is created or retain the power, or grant it to others, to decide which charities receive the property when the trust ends.

The amount of the income tax deduction may be affected by the status of the charitable remainderman. Both the percentage ceiling on the deduction and whether the deduction is measured by the fair market value or the basis of the contributed assets depend on whether the remainderman is a public charity, such as The New York Community Trust, or a private foundation.

The flexibility of The New York Community Trust makes it an ideal remainderman. The Trust offers four types of funds. For people who want to contribute to the vitality of their communities, an unrestricted fund provides maximum flexibility. For those with a particu-

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lar area of concern, such as education or health, a field-of-interest fund may be the perfect vehicle. Designated funds allow a donor to specify one or more institutions to benefit, and donor-advised funds enable advisors named by the donor to suggest non-profit organizations to receive grants from the fund.

When The New York Community Trust is the beneficiary of a CRT, it will consider serving as trustee. Please contact us to discuss if our involvement as trustee would be appropriate.

#### For further reference, see:

Code Section 170(f)(2): Gifts of split interests in property.

Code Section 664: Charitable remainder trusts.

Treasury Reg. Sec. 1.664-1(d)(1): Character of distributions from CRTs.

Code Section 2055(e): Bequests of split interests.

Code Section 2522(c): Gift tax deduction for charitable gifts.

Estate of Atkinson v. Commissioner, 309 F. 3d 1290 (11<sup>th</sup> Cir. 2002), *aff'g* 115 T.C. 26 (2000).

Revenue Ruling 77-374, 1977-2 C.B. 329.

Revenue Ruling 92-48, 1992-1 C.B. 301.

Revenue Procedure 2005-24, 2005-1 C.B. 909.

Revenue Procedures 2003-53 - 2003-60, 2003-2 C.B. 230 - 274.

Private Letter Ruling 9452026.

Notice 94-78, 1994-2 C.B. 555.

Notice 2006-15, 2006-1 C.B. 501

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## About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of \$2 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee; investment fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

### **Long Island Community Foundation**

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