THE CRT
A TRUST FOR ALL SEASONS

PG CALC WEBINAR

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I. Introduction

Charitable remainder trusts (CRTs) have been far less popular this century than in the 1990s. That fact has resulted from the decrease in family wealth following the plunge of stock and real estate values, personal insecurity causing people to be reticent to make irrevocable gifts, reduced tax incentives, and charities focusing more on current needs.

Now there are favorable factors for a revival of CRTs. During the past two years stocks have performed quite well, real estate values have been rebounding, the tax rate on capital gain for affluent taxpayers is now the highest it has been since 1997, the top income tax rate is back where it was at the turn of the century, and the very numerous Baby Boom generation is approaching the age range when many people establish CRTs.

While these external factors create a more favorable climate for charitable remainder trusts, we can stimulate their revival by showing how they can serve objectives at every season of life, not just for those in the upper ages. This paper will focus on selected applications appropriate for donors or beneficiaries at each season of life. Although our division is somewhat arbitrary, we will define the seasons of life as follows:

Springtime of life – ages 1-39

Summer of life – ages 40-59

Autumn of life – ages 60-79

Winter of life – ages 80+

Following are the applications of CRTs to be discussed:

Springtime of Life

1. Provide expenses for a college education
2. Diversify assets and trade stocks without concern about capital gain.

Summer of Life

1. Enhance retirement income with a supplemental retirement plan
2. Help cover expenses of elderly parents

Autumn of Life

1. Sell a family business and minimize taxes.
2. Convert commercial property to a stream of income without management responsibility.
3. Lock in gain from tangible property and receive income.

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Winter of Life

1. Provide predictable cash flow during the later years of life.
2. Provide for heirs using retirement funds remaining at death.

In all of these applications, philanthropic intent is presupposed. Also, it is presumed that the reader has a basic familiarity with CRTs. However, for those who may not be as knowledgeable about them, there is an appendix covering the essentials. Unless otherwise noted, the examples are based on quarterly payments at the end of the quarter and a Section 7520 rate of 2.0 percent.

II. APPLICATIONS OF CHARITABLE REMAINDER TRUSTS DURING THE SPRINGTIME OF LIFE

"*The rose upon my balcony the morning air perfuming,*
Was leafless all the winter time and pining for the spring."
William Thackeray

A. Objective: Provide Expenses for a College Education

1. Situation

David and Linda, both age 64, want to pay a substantial portion of the college expenses of their granddaughter, who is seven years old. They also want to make a gift to a favorite charity and minimize taxes.

2. Solution

David and Linda contribute stock having a value of $200,000 and a cost basis of $40,000 to a CRT that is structured initially as a net-income with make-up charitable remainder unitrust ("NIMCRUT") and name their granddaughter as the income beneficiary. The trust features a 14.5-year term and a 10-percent payout rate, and it will "flip" (i.e., convert) to a standard charitable remainder unitrust ("SCRUT") once the granddaughter has attained age 17. The trustee sells the contributed stock and plans to invest the proceeds in a diversified growth portfolio for the next 10.5 years, realizing just enough dividends to cover administrative expenses. Each year after the trust flips, the trustee will sell enough shares to make the trust payments to the granddaughter. The total return on trust assets, net of administrative expenses, is presumed to average 5.5 percent. Payments are semi-annual at the end of the period, and the applicable Sec. 7520 rate is 1.4 percent.

Date of gift July 1, 2013

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Date of triggering event	July 22, 2023, the granddaughter's 17th birthday. The trust starts functioning as a SCRUT on January 1, 2024.
Presumed value of trust assets on January 1, 2024 (constant net return of 5.5%)	$350,898

Semi-annual payments to granddaughter:

June 30, 2024	$17,545
December 30, 2024	17,545
June 30, 2025	16,744
December 30, 2025	16,744
June 30, 2026	15,981
December 30, 2026	15,981
June 30, 2027	15,252
December 30, 2027	15,252

Amount remaining for charity	$288,116
Total payments to granddaughter:	$131,044

Tax Implications

- Income tax charitable deduction for grandparents – $44,196. Assuming a marginal tax rate of 35 percent, their tax savings would be $15,469.

- Taxable gift to granddaughter – $155,804

  Through gift splitting, David and Linda reduce the taxable gift by $28,000, and each then uses some of his or her lifetime gift tax and generation-skipping tax exemptions to cover his or her half of the remaining $127,804 of the taxable gift. They could have postponed a completed gift by retaining by will the right to revoke their granddaughter's income interest. If the beneficiaries of a CRT are other than the donor, and the trust makes payments for the life of the beneficiaries, the donor cannot retain the right to revoke by will the beneficiaries' income interests. In that case, the trust would potentially be measured by the donor's life rather than the lives of the beneficiaries, and this would disqualify the trust. However, a non-beneficiary donor can retain the right to revoke by will the income interests

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of the beneficiaries if the trust is for a term of years. The trust qualifies because if the power to revoke is exercised, the trust is still measured by a term of years, albeit a shorter term. See Reg. Sec. 1.664-3(a)(5)(i) and Private Letter Ruling 8949061.

- Income is taxed to the granddaughter under the four-tier system. Unfortunately, under the "Kiddie Tax" rules unearned income above the applicable threshold and reduced by applicable deductions is taxed at the highest marginal rate of the parents. This may have minimal consequence if much of the trust payment consists of capital gain.

- David and Linda are not taxed on the capital gain in the stock they contribute.

Variations

The grandparents could have funded the trust just before their granddaughter was ready to start college. If they had done that they would not have had the extra years of tax-free growth. If they wanted to provide fixed payments, they could have waited until time to start college and then established a term-certain charitable remainder annuity trust (CRAT). The trust term could have been set so that payments for college expenses would have been made over a period longer than four years since students often take five years or more to earn a degree. There are, of course, non-charitable plans, such as a 529 plan, for funding a college education. This example pertains to those who want simultaneously to provide for college expenses and make a charitable gift.

3. Why an Educational CRUT May Be Preferable to a College Annuity*

- The amount of payments during the college years is potentially much larger because the compound interest credited during the deferral period of deferred gift annuities is a modest 3.25 percent.

- A larger percentage of income may be taxed at capital gains rates rather than ordinary income tax rates.

- The 10-percent penalty tax per IRC Sec. 72(q) does not apply to the CRUT payments as it would to the deferred gift annuity installments.

* The college annuity is a deferred gift annuity with life payments typically starting when the annuitant is age 18. At some point prior to that date, the stream of payments that was to have been made over the life of the annuitant starting at age 18 is commuted to a series of larger payments made over a period of four or five years starting at age 18, i.e., during the period the student is expected to be in college.

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B. Objective: Diversify Portfolio and Then Trade Stocks without Concern about Capital Gain

1. Situation

Sharon, currently age 39 but due to turn 40 in a couple of months, owns 50,000 shares of AA company, a high-tech firm, where she has worked for a number of years. A year ago, the stock was selling for $70 per share, and the price has now dropped to $50 per share. Still, it is highly appreciated. She acquired 20,000 shares for $4 per share, 20,000 shares for $8 per share, and 10,000 shares for $15 per share. She also owns other stocks with a combined value of $1,200,000 and a combined cost basis of $600,000. Although she has confidence in her company, she recognizes that it operates in a very competitive environment, and she is nervous about having so much of her net worth in a single stock. She has hesitated to sell, however, because she doesn't want to lose some of the proceeds through capital gains taxation. Sharon is single and plans eventually to leave a significant portion of her estate to charity, but she does want to make modest provision for four nieces and nephews and for a few friends. She enjoys studying the market and would like somehow to be involved in the investment of trust assets. At this time, her $300,000 salary is sufficient for her lifestyle apart from any investment income. However, she wants to retire at age 55, and at that time she would like additional cash flow.

2. Solution

Sharon contributes 20,000 shares of AA stock, which she acquired at $4 per share and which are now worth $1,000,000, to a NIMCRUT with a five-percent payout rate that will flip to a SCRUT once she has turned age 55. She is the sole income beneficiary, and payments will be made to her for the duration of her life. She names herself as trustee and, in consultation with her financial advisor, takes responsibility for investing trust assets, but she outsources trust administration and tax filing. In her capacity as trustee, she sells the AA stock and invests the proceeds in a diversified growth-oriented portfolio. Trust income, net of administrative expenses, is approximately one percent of the value of trust assets until the trust flips, and she contributes this one percent to charity since she has adequate cash flow from her salary and investments.

The gift results in an income tax charitable deduction of $176,300, which reduces the tax she is currently paying on her salary.

At age 55, she will start receiving five percent of the value of trust assets, and those assets could have grown to several million dollars by then.

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This plan is even more appealing to people like Sharon because the tax rate she would pay on the capital gain, if she sold the stock, has risen from 15 percent to 18.8 percent as a result of the new health care surtax.

Her NIMCRUT functions rather like a self-directed IRA. She can make buy-and-sell decisions at any time based on market conditions and her judgment of a stock's future rather than on the tax consequences. Unlike the IRA, to which contributions are limited, she can make additions of any amount at any time to the CRT, which is her trading account.

III. Applications of Charitable Remainder Trusts During the Summer of Life

"*Life is no brief candle to me.*
It is a sort of splendid torch which I have got hold of for the moment,
and I want to make it burn as brightly as possible
before handing it on to future generations."
George Bernard Shaw

A. Objective: Provide a Supplemental Retirement Plan

1. Situation

Dr. Klein has been contributing the maximum allowable to his qualified retirement plan, and he would like to accumulate more for retirement on a tax-favored basis. He has some stocks that have performed well, but he thinks it would be prudent to reduce his position in some of them. Specifically, he would be willing to transfer 5,000 shares of Z stock, which is now selling for $40 per share. In addition to this initial transfer, he believes he could contribute approximately $40,000 per year towards his future retirement. Dr. Klein and his wife are both age 50, and they would like to retire no later than the year they turn age 65. They have two adult children, ages 25 and 23, but they believe they can make significant transfers to a charitable instrument and still provide adequately for the children.

2. Solution

To establish a substantial supplemental retirement plan they create a NIMCRUT with a five-percent payout rate and initially fund it with 5,000 shares of Z stock valued at $200,000. Then at the beginning of each year, for the next 10 years, they add $40,000 in cash and/or securities to the trust. The trust contains a provision that causes it to flip from a NIMCRUT to a SCRUT effective the year Dr. Klein turns age 65.

The trustee invests in a diversified growth-oriented portfolio, at least until such time as the trust flips. The dividends from these stocks are just sufficient to cover trust

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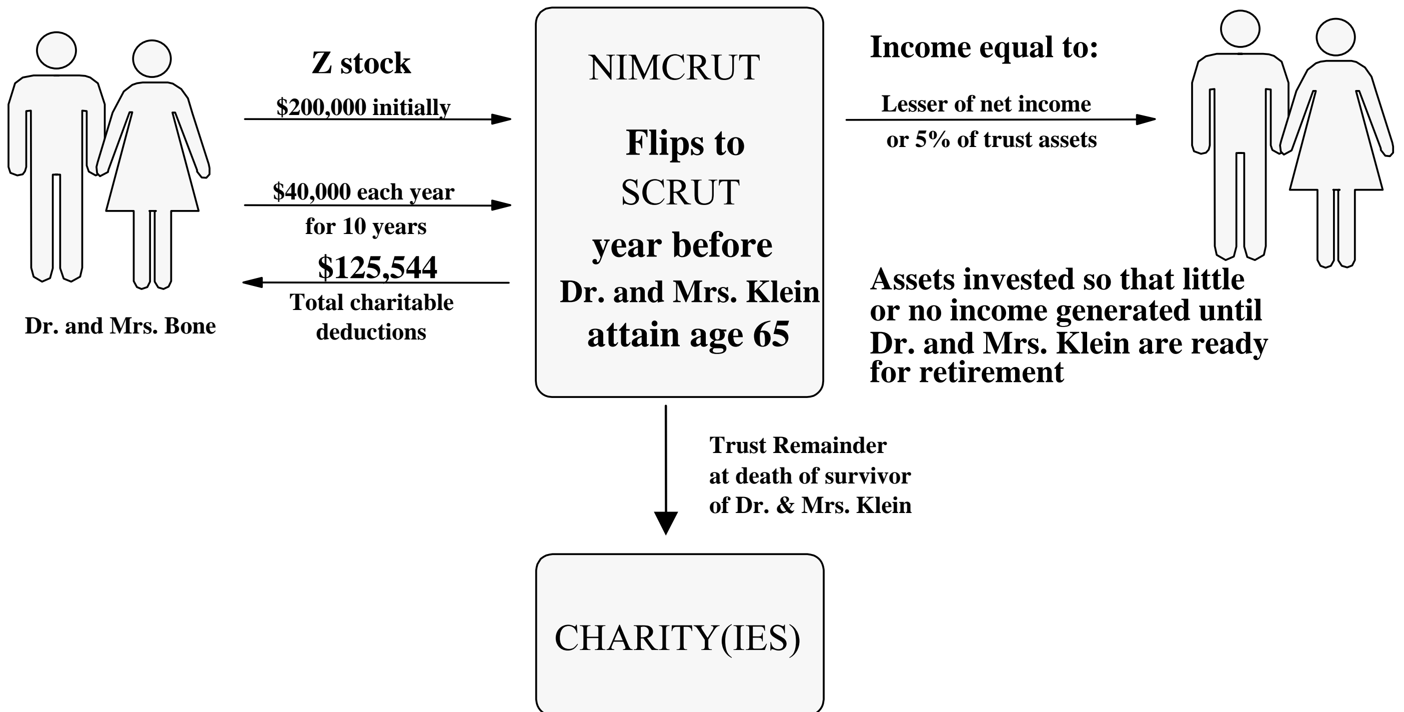
administration fees, so Dr. and Mrs. Klein don't actually receive any income until the trust flips to a SCRUT. Meanwhile, the trust principal appreciates at a rate of 5.5 percent per year. After flipping, the trust's total return (net of trustee fees) continues to be 5.5 percent. (Note: If interest and dividends exceed the cost of trust administration, then the excess would be paid to Dr. and Mrs. Klein. The assumption is that trust assets grow at the rate of 5.5 percent after deducting administrative costs and any distributions to the income beneficiaries.)



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PROJECTED CASH FLOW[1]

Ages of Donors	Contribution	Deduction	Trust Value Beginning of Year	Unitrust Amount	Trust Payments	Deficiency End of Year[2]
50/50	$200,000	$34,988[3]	$200,000	$12,000	- 0 -	$12,000
51/51	40,000	7,329	251,000	12,550	- 0 -	24,550
52/52	40,000	7,674	304,805	15,240	- 0 -	39,790
53/53	40,000	8,034	361,569	18,078	- 0 -	57,868
54/54	40,000	8,408	421,455	21,073	- 0 -	78,941
55/55	40,000	8,797	484,635	24,232	- 0 -	103,173
56/56	40,000	9,200	551,290	27,564	- 0 -	130,737
57/57	40,000	9,616	621,611	31,081	- 0 -	161,818
58/58	40,000	10,048	695,800	34,790	- 0 -	196,608
59/59	40,000	10,494	774,069	38,703	- 0 -	235,311
60/60	40,000	10,956	856,643	42,832	- 0 -	278,143
61/61	- 0 -		903,758	45,188	- 0 -	323,331
62/62	- 0 -		953,465	47,673	- 0 -	371,004
63/63	- 0 -		1,005,906	50,295	- 0 -	421,299
64/64	- 0 -		1,061,231	53,062	- 0 -	474,360[4]
TRUST FLIPS FROM NIMCRUT TO SCRUT END OF THIS YEAR						
65/65	- 0 -		1,119,599	55,980	55,980	- 0 -
66/66	- 0 -		1,125,197	56,260	56,260	- 0 -
67/67	- 0 -		1,130,822	56,541	56,541	- 0 -
68/68	- 0 -		1,136,476	56,824	56,824	- 0 -
69/69	- 0 -		1,142,158	57,108	57,108	- 0 -

Etc. until the death of the survivor of Dr. and Mrs. Klein.

Total charitable deduction $125,544

(1) As noted above, these projections are based on a constant return of 5.5 percent (net of the cost of trust administration). In actuality, the returns will fluctuate yearly, and the average over the life of the trust could be more or less than 5.5 percent. A constant-return assumption is used to illustrate how a flip unitrust works.

(2) Each year prior to the flip the difference between the unitrust amount and actual trust payments is added to the deficiency account. In any subsequent year that income exceeds the unitrust amount, the excess income is paid out to the extent of the accrued deficiency.

(3) Because all deductions were calculated based on 2.0 Sec. 7520 rate, those associated with contributions made in future years could be slightly higher or lower depending on the movement of the rate.

(4) Once a NIMCRUT flips to a SCRUT, the accrued deficiency is forfeited.

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3. Commentary:

The triggering event of a flip trust can be a specific date, or an event "whose occurrence is not discretionary with, or within the control of, the trustees or any other persons." The sale of an unmarketable asset will not be considered discretionary or within the control of the trustees or any other persons. See Reg. Sec. 1.664-3(a)(1)(c) and (d).

Thus, the donor might contribute to the trust an illiquid asset (e.g., a small piece of real estate, a share of closely held stock, or an article of tangible property), and the trust could flip when the trustee sells that asset. The triggering event in Dr. Klein's case is the attainment of a certain age.

Dr. Klein may choose to retire earlier than age 65. Even if he doesn't retire earlier, he might like to get money out of the CRT for an investment, an around-the-world cruise, the purchase of a retirement condominium, or something else.

For example, when they reach age 63, Dr. and Mrs. Klein might like to have $200,000 to invest in a retirement home. Their trustee could liquidate securities realizing a gain of $200,000. The entire gain could then be distributed to them because the percentage amount plus accrued deficiency at that time exceeds $200,000. This would, of course, reduce the amount of their retirement income. Another disadvantage of defining income to include realized capital gain is that the trustee might deem it wise to sell certain appreciated securities because of market conditions, and this would force distributions to the beneficiaries when they do not want them and which would reduce future retirement accumulations.

Some practitioners have sought to transform a NIMCRUT into a "spigot" trust (able to turn income on and off as desired) by having the trust invest in a commercial deferred variable annuity and defining income to include distributions of gain from the annuity. There are three problems with this arrangement: (1) All distributions would be taxed as ordinary income; (2) if there is no gain in the variable annuity, no distributions can be made; (3) there are usually surrender charges if one wants to surrender the variable annuity and invest the proceeds in some other way.

Another charitable instrument for supplementing retirement income is a deferred gift annuity, particularly a flexible deferred gift annuity. The advantages of the flexible deferred gift annuity are that no payments are made until the desired beginning date, one can decide later when to begin payments, the payments beginning at any age are fixed and not dependent on market returns. The advantages of the NIMCRUT with the "flip" provision are that the return on trust assets may be higher than the compound interest credited on a deferred gift annuity and that trust income could increase, offering inflation protection. If a charity does not offer gift annuities, then the NIMCRUT may be the only charitable option for those wanting to make a gift and accumulate more for retirement.

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A person wanting to accumulate for retirement can contribute to an IRA or qualified retirement plan, invest in a taxable brokerage account, establish a NIMCRUT, or fund a flexible deferred gift annuity, or some combination of them. The first three of these options are compared in the chart below.

	IRA or Qualified Plan	Outside Account	NIMCRUT
Deduction for initial investment	Yes	No	Partial deduction
Account or trust exempt from taxation	Yes	No	Yes
Type of assets that can be transferred to account or trust	Cash only	Cash or appreciated securities	Cash or appreciated securities
Mandatory distribution during pre-retirement period	No	No	Yes, but can be limited by choice of investments
Maximum tax rate applicable to distributions of capital gain and dividends	39.6%	23.8%	23.8%
Mandatory distributions after retirement	Yes, beginning at age 70½	No	Yes, per terms of trust

B. Objective: Help Cover Expenses of an Elderly Parent

1. Situation

Some elderly individuals live with adult children. Others live in a retirement home, but their income from Social Security, pensions, and investments is insufficient to cover their expenses. Thus, they need a subsidy from adult children, who are often in their 40s and 50s and may also be funding the college education of their children. Sandra is one of those adult children in the sandwich generation. Fortunately, she and her husband have good incomes and a fair amount of investments in securities, some of which have considerable appreciation. Currently she is paying $1,000 per month for her 81-year-old

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mother's care, and these payments are made with after-tax income. Since she and her husband are in a 35-percent tax bracket it takes $1,538 of pre-tax income to net the $1,000.

<u>Solution</u>

Sandra and her husband contribute $200,000 of stock to a charitable remainder annuity trust with a 6.5 percent payout rate and name Sandra's mother as income beneficiary. The cost basis of the stock is $40,000, and they elect the October 2013 Sec. 7520 rate of 2.4 percent. The payments will be made monthly. Sandra's mother will receive $1,083 per month which, after her very modest income taxes, will still be in excess of the $1,000 per month she had been receiving. Sandra and her husband receive an income tax charitable deduction of $110,018 which saves them $38,506 in income tax, and they are not taxed on the capital gain in the stock. The $4,000 of dividends they forfeit on the contributed stock is well below the amount they were paying for Sandra's mother's care, so their spendable income increases. Sandra conferred with her mother about the purpose of the gift, and they decided that the trust remainder would be used to establish an endowment named for her mother and father. This was immensely satisfying to her mother.

Sandra and her husband could have established a gift annuity for her mother with some of the same benefits. However, they would have been taxed on some of the capital gain in the stock because the annuitant is someone other than the donor.

IV. APPLICATIONS OF CHARITABLE REMAINDER TRUSTS DURING THE AUTUMN OF LIFE

"*No spring, nor summer beauty hath such grace,*
As I have seen in one autumnal face."
John Donne

A. Objective: Sell a Family Business and Minimize Taxes

1. <u>Situation</u>

Some business owners have one or more children who would like to continue to operate their business. In that case, the challenge is how to transfer the business to those children while being fair to their other children. Other owners have no children interested in the business, so they try to sell the business when they are ready to retire. By using a CRT they may be able to reduce the taxes they would otherwise incur while providing retirement income. Before suggesting a CRT, it is necessary to determine whether the company is a C corporation, an S corporation, or a limited Liability company (LLC). Below are some possible ways to use a CRT in each case.

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2. Solution

Scenario 1 – John and Jane Green own all of the stock in a C corporation.

John and Jane can contribute all or a portion of their stock to a CRT.
The ideal situation would be to find someone who would purchase the stock from the CRT. However, the buyers of the business may be unwilling to purchase the shares of the corporation because of concern about the liabilities they might assume and because they want to be able to depreciate assets held by the corporation, so they insist on purchasing assets of the corporate business. In that case, the corporation sells its assets, pays tax on the gain, and soon thereafter is dissolved, with the net proceeds paid to the CRT, which owns the company. Because the CRT is tax-exempt, it is not taxed on the proceeds received from the corporation upon liquidation of its assets.

If John and Jane had retained the stock in the business, sold the assets of the corporation, and then dissolved the corporation and paid the proceeds to themselves, they would have been taxed on proceeds received from the corporation upon liquidation of its assets. This would have been in addition to the tax paid at the corporate level. With the CRT, they avoid at least one level of taxation.

Possibly, a corporation will have sold its assets and purchased marketable securities, making it a personal holding company subject to the punitive tax that effectively forces it to distribute most of its income as taxable dividends to the shareholders. A CRT can make sense in this situation because, again, one level of taxation is avoided. Although the corporation will have to pay tax on liquidated assets, the shareholder (i.e., the CRT) is not taxed on the gain in the personal holding company stock.

Suppose that John and Jane want to make a substantial gift, but they are not ready to sell the business and retire. Suppose further that the company comprises most of their wealth and that the company has considerable cash reserves.

They could contribute a fraction of their shares to the CRT, and the corporation could subsequently redeem those shares, subject to the following conditions and procedures:

The charitable donee cannot be legally bound or compelled to sell the donated shares to the corporation or any other person or entity. *Palmer v. Commissioner*, 62 TC 684 and Rev. Rul. 78-197. Otherwise, the sales proceeds will be treated as a taxable dividend.

A purchase of shares by the corporation from a CRT will not be self-dealing provided (a) the trust receives no less than fair market value for the stock, and (b) an offer of redemption is made to all persons who hold securities of the same class. See Reg. Sec. 53.4941(d)-3(d)(1).

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The corporation or other non-related shareholders may have a right of first refusal – i.e., a right to purchase the stock for fair market value – in the event the charity decides to sell. Private Letter Ruling 8042030. The right of first refusal does not obligate the charity to sell and thus meets the conditions of Rev. Rul. 78-197.

Scenario 2: John and Jane own all of the shares in an S Corporation.

S Corporation stock cannot be given to a CRT. However, the S Corporation can contribute appreciated assets to a term-certain CRT. The S Corporation would be the income beneficiary. The charitable deduction would be passed through to the shareholders and could be used to the extent of their basis in the S stock plus appreciation in the contributed asset, subject to the 30-percent of AGI deductibility limitation. See Private Letter Ruling 9340043, in which the IRS ruled that an S Corporation can be the donor of a CRT. (Note: These gifts are now somewhat more attractive because the basis in a shareholder's S stock is reduced only by his pro rata share of the cost basis of the contribution.)

Suppose that the S corporation owns real estate with a fair market value of $800,000 and a cost basis of only $200,000, and that the shareholders would like to dispose of this property. The S corporation could contribute it to a CRT for a term of years, and the CRT could then sell the property. The payments would be made to the corporation and then paid to the shareholders. The income tax charitable deduction would be passed through to them, and they would not be taxed on the capital gain when the property was transferred to and sold by the CRT.

If there were a buyer willing to purchase all of the assets of the S corporation (but not the stock) conceivably all of the assets could be transferred to the CRT and then sold by it. This would necessitate the S corporation's continuing in existence for the duration of the trust term.

When an illiquid assets are transferred to a CRT, one would normally choose a flip CRUT with the triggering event being the sale of the asset.

Scenario 3: John and Jane are the only members of an LLC that owns rental real estate.

LLC interests can be transferred to a CRT, provided the operating agreement permits the CRT to be an owner. If all of the income of the LLC is passive – i.e. derives from rent – the CRT will not have any unrelated business taxable income (UBTI). However, if the LLC is an operating business or has debt-financed income the CRT's share of business or debt-financed income would be subject to a 100-percent tax in the trust. A CRT funded with an LLC interest works best when the LLC does not have any encumbered property and has passive income. The appropriate instrument would be a flip unitrust.

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B. Objective: Be Relieved of Management Responsibility and Receive Life Income

1. Situation

Harry and Louise have owned a 24-unit apartment building for the last 19 years. Harry, now age 74, has done much of the maintenance work himself, and he and Louise, age 73, have collected the rents and paid the bills. A few months ago he suffered a mild heart attack and has been ordered by his physician to slow down. He and Louise had been considering whether to sell the property or keep it and hire a manager when they read a story in their charity's newsletter about another couple who transferred property to a CRT.

Pursuant to an inquiry, the planned giving officer meets with them and ascertains this information:

- *Gross rents are $200,000 per year.*
- *Real estate taxes, insurance, and other expenses are about $60,000 per year.*
- *Their adjusted cost basis in the property is only $300,000 because they have been systematically depreciating the building, which they purchased for $1,100,000.*
- *The property was recently appraised for $2,400,000.*
- *They have one daughter, age 50, whom they have provided with other assets, but they wonder if there is a way she might also benefit from this property.*

2. Solution

Following a discussion with their advisors, they decide to contribute the property to a flip CRUT that will become a SCRUT on the January 1 following the sale of the property. The trust will have a 6.0-percent payout rate.

The duration of the trust will be the longer of their lives or 20 years. Payments will be made to them jointly, then to the survivor, and if both of them die within 20 years, to their daughter for the balance of the 20-year period.

Six months later the property sells for $2,400,000, and net proceeds are $2,230,000. During the first year following the sale, Harry and Louise receive $133,800. Payments each year thereafter will depend on the earnings of the trust.

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Harry and Louise receive an income tax charitable deduction of $671,808, which will be subject to the 30-percent-of-adjusted-gross income annual ceiling.

They avoid taxation of gain when the property is transferred to the trust, and the trust, being tax-exempt, is not taxed on the gain when it sells the property. If Harry and Louise had sold the property, the capital gain attributable to depreciation would have been taxed at 28.8 percent, including the healthcare surtax.

Harry and Louise are able to unburden themselves of responsibility for the property, which is particularly welcome given Harry's failing health.

In the event of their premature death, they provide payments to their daughter for a period of time in addition to the other legacy they have arranged for her.

When real estate is contributed for a CRT, it is a good idea to suggest to a donor that he or she serve as trustee until the property is sold. Then the donor could resign and appoint the charity or a financial institution as successor trustee. This protects the charity from liability in case there should be any environmental problems. Also, the charity is protected from criticism by the donor if it sells the property for a price below what the donor thinks it is worth.

In order to pay out the entire net income from the real estate prior to the time that the unitrust flips, the payout could be such that the payout rate multiplied by the appraised value is less than the actual net income.

C. Convert Tangible Personal Property to a Stream of Income

1. Situation

Tim and Michelle, ages 70 and 69, purchased a painting many years ago for $20,000 when the artist was not yet well known. In the meantime, the artist has become famous, and the painting was recently appraised for $250,000. Having retired, they would like to increase their income. There is a ready market for the painting, but they hesitate to sell it because the $230,000 of gain would be taxed at a rate of 31.8 percent (the top 28-percent rate applicable to tangible personal property plus the 3.8 percent healthcare surtax.

2. Solution

In late 2013 they contribute the painting to a flip unitrust with a 6.0-percent payout rate, naming themselves as trustee, and in 2014 in their capacity as trustee, they sell the painting for $250,000, netting $230,000 after selling costs. The entire net proceeds can be reinvested to generate income, which in 2015 will be $13,800 ($230,000 x 6.0 percent). If they had sold the painting, only $163,220 after-tax would have been available for investment.

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Their income tax deduction will be postponed until 2014, and it will be for the present value of the remainder interest determined as of the date of the sale. However, a gift-tax charitable deduction for the present value of the remainder interest would be allowed at the time of the gift. The reason for the postponement of the income tax charitable deduction is that IRC Sec. 170(a)(3) provides that a contribution of a future interest in tangible personal property is not considered to have been made until the expiration of the intervening interest in property held by the donor or a related person. Upon the sale of the object, the donor holds an intervening interest in the sales proceeds but not in the property itself, so the deduction would then be allowed. Since the painting was given for an unrelated purpose, the deduction will be based on the cost, so it will be quite small. The real benefit is not the deduction but converting an idle asset to income with no immediate taxation of the capital gain.

In the autumn of life, individuals often want to simplify life and generate a secure retirement income. To achieve these objectives they may be considering selling a business, rental property, or collectibles. In each case, as this section has demonstrated, a CRT can be an appropriate vehicle for them.

V. Applications of Charitable Remainder Trusts During the Winter of Life

"*When you are old and grey and full of sleep,*
And nodding by the fire, take down this book,
And slowly read, and dream of the soft look
Your eyes had once, and of their shadows deep."
William Butler Yeats

A. Objective: Provide Predictable Cash Flow during the Later Years of Life

1. Situation

Keith and Marilyn, both age 84, have various appreciated stocks in their brokerage account with a combined value of $500,000 and a cost basis of $200,000. Their annual dividend income is approximately $10,000 (i.e., two percent of the value of the stocks). They would like to increase cash flow, not worry about market fluctuations, and arrange a memorial endowment.

2. Solution

They transfer the stock to a charitable remainder annuity trust ("CRAT") with a seven-percent payout rate. The two of them jointly, and then the survivor, can count on $35,000 per year for life, which is 3.5 times the dividends they are

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currently receiving. Their trust payments will likely be taxed partly as ordinary income and partly as capital gain, but none of the gain will be taxed to them when they transfer the stock or to the trust when it sells the stock. Another benefit is an income tax charitable deduction that will reduce income tax over the period they use the deduction.

Value of stock contributed	$500,000
Income tax charitable deduction	$181,575*
Annual trust payments	$35,000

* Based on a 2.4-percent Sec. 7520 rate.

Because of their ages, Keith and Marilyn elected a relatively high payout rate. Unless the return on invested trust assets is consistently strong, there is likely to be some erosion of trust principal. Still, a significant amount should remain in the trust at termination to be used for their designated charitable purpose.

Note: Ordinarily, a CRAT is better than a CRUT when the income beneficiaries have reached that stage of life when the security of predictable payments is more important than the potential for income growth. An alternative would have been for Keith and Marilyn to establish a gift annuity, although the gift annuity rate currently recommended by the American Council on Gift Annuities for a pair of persons their age is only 6.5 percent.

B. Objective: Provide for Heirs with IRA Funds Remaining at Death

1. Situation

Charlotte has an estate of approximately $7,000,000, including over $1,000,000 in an IRA. She wants most of her estate, less applicable estate taxes, to go to her two sons. However, she has indicated that she would consider a gift of IRA assets remaining at her death if she could reduce her taxes and also benefit her sons.

2. Solution

When Charlotte dies, her remaining retirement funds – which at that point total $1,000,000 – are paid to a SCRUT, which will make payments to her two sons for 20 years. Then the trust will terminate, and the remaining principal will be distributed to her favorite charity for an endowment in her name. Since the trust has a five-percent payout rate, her sons initially receive $50,000 per year, but this will increase over time if the total return on trust investments exceeds five percent.

If she had simply designated that the $1,000,000 left in the IRA upon her death be distributed outright to her sons, the entire amount would have been subject to $400,000 of federal estate tax (not taking any state estate tax into consideration), assuming all of her estate went to her sons. However, the trust results in the amount

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subject to estate tax being reduced by $363,150, based on a Sec. 7520 rate of 2.0 percent.

The trust payments will be taxed as ordinary income. If she had simply named her sons as beneficiaries of her IRA, and they had received periodic payments over their life expectancy, the payments would also have been taxed as ordinary income.

With this arrangement, she potentially saves estate tax, assuming her estate exceeds the exemption amount, and she assures a charitable gift while benefiting her sons. The latter might have been a sufficient reason to establish the trust even if her estate would not be subject to estate tax.

The plan can be implemented in any of the following ways**:**

- The donor establishes a CRT during life, minimally funds it, and names the trust as beneficiary of the IRA. The disadvantage is annual tax filings prior to the donor's death.

- The donor executes a trust instrument during life, does not fund it then, and names the trust as beneficiary of the IRA. It is important to determine that such a "dry trust" would be recognized in the applicable jurisdiction.

- The CRT is created under the will and is named as beneficiary of the IRA. This presumes that the trust would be deemed to be established at the moment of death so that it can be named as beneficiary.

- The donor creates a revocable trust which becomes an irrevocable CRT at the moment of death, and names the trust as beneficiary of the IRA. The revocable trust is funded with a minimal amount, say $10, and no filings are required.

Note: It would also have been possible for Charlotte to have used the assets in her IRA to establish a gift annuity for her sons (or separate gift annuities for each of them) upon her death. See Private Letter Ruling 200230018. Of course, the applicable gift annuity rate(s) might not have been as suitable, payments would need to have continued for life, and there would be no possibility of the payments increasing from one year to the next.

VI. SUGGESTIONS FOR INCREASING THE NUMBER OF CRTs

1. As this paper has demonstrated, CRTs can be appropriate for donors and beneficiaries at every stage of life. Therefore, don't market them just to older individuals with the presumption that they will be the income beneficiaries. Broaden the market.

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2. Remember that conditions are more favorable for CRTs now than they have been in quite a long time. The tax incentives have increased, and once again many people have highly-appreciated real estate and securities. Therefore, start putting more emphasis on them in your marketing materials.

3. Make people aware that CRTs can be funded with a variety of assets – real estate, closely held stock, LLC interests, tangible personal property etc. Don't limit your examples to CRTs funded with cash and publicly-traded securities.

4. If necessary, revise your gift acceptance policies. Some of these policies are too restrictive on the types of acceptable assets, and they don't allow trusts with payout rates above five or six percent. Instead of limiting the payout rate, consider requiring that the present value of the remainder interest be a certain amount. Some charities would refuse a 10-year, 10-percent payout-rate CRUT funded with $4,000,000 but would accept a 5.0-percent payout-rate CRUT, funded with $100,000, with income payable over the life of a 65-year old. This makes no sense.

5. Make the establishment of a CRT a seamless process. Generally, the charities that complete the most CRTs offer to serve as trustee and outsource investment and administration to a financial institution, and they guide the donor through every step.

6. Be creative and show how a CRT, or a CRT in combination with another arrangement, can be a solution to donor situations.

AFTERWORD

"For everything there is a season,
And a time for every matter under heaven:

A time to be born, and a time to die;
A time to plant, and a time to pluck up what is planted;

A time to kill, and a time to heal;
A time to break down, and a time to build up;

A time to weep, and a time to laugh;
A time to mourn, and a time to dance…"

Ecclesiastes 3:1-4

But for a charitable remainder trust there is no one season. It is, indeed, a trust for all seasons.

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APPENDIX

Overview of Charitable Remainder Trusts

A. Description of a Charitable Remainder Trust (CRT)

A CRT is an irrevocable trust, established by the trustor(s) either during life or at death, which pays to one or more beneficiaries, at least one of whom or one of which is not a charity, for the lifetime(s) of one or more individual beneficiaries, or for a term not exceeding 20 years, a specified amount until the termination of the trust, at which point the trust remainder is paid to, or for the use of, one or more charitable organizations. The specified amount paid to beneficiaries must be either (1) an annuity amount, i.e., a fixed dollar amount, which is not less than 5 percent or more than 50 percent of the initial fair market value of the property transferred to the trust or (2) a unitrust amount, i.e., a fixed percentage, which is not less than 5 percent or more than 50 percent of the net fair market value of trust assets re-valued annually.

B. Types of CRTs

Charitable Remainder Annuity Trust (CRAT) – Pays to beneficiaries a sum certain, which must not be less than 5 percent or more than 50 percent of the initial fair market value of the assets transferred to the trust, even if principal must be invaded. IRC Sec. 664(d)(1). (Appeals to older individuals who want the security of predictable income.) Subsequent transfers of assets are not permitted.

Charitable Remainder Unitrust (CRUT) – Pays to beneficiaries a fixed percentage, which must be not less than 5 percent or more than 50 percent of the value of trust assets as re-valued annually. IRC Sec. 664(d)(2). (Appeals to individuals who would like for income to keep pace with inflation if possible, although there is also a risk that income will decrease from one year to the next.) Subsequent transfers of assets are permitted.

These variations of a CRUT are permissible:

- Standard Charitable Remainder Unitrust (SCRUT) – Pays the fixed percentage even if principal must be invaded.

- Net-income Charitable Remainder Unitrust (NICRUT) – Pays the lesser of the fixed percentage or actual net income. IRC Sec. 664(d)(3)(A). Principal may not be invaded.

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- Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT) – Pays the lesser of the fixed percentage or actual net income, but can pay make-up distributions to beneficiaries to the extent of accrued past deficiencies in payments. IRC Sec. 664(d)(3)(B). Again, principal may not be invaded.

- "Flip" Trust – Treasury regulations permit a NICRUT or NIMCRUT to flip to a SCRUT upon the occurrence of a triggering event. The change is effective at the beginning of the taxable year immediately following the taxable year in which the triggering event occurs. Reg. Sec. 1.664-3(c). If the trust starts out as a NIMCRUT, any make-up amount not paid out by the end of the year in which the triggering event occurs is forgone. A trust may flip only once.

Payments are typically made quarterly at the end of the calendar quarter, although they can also be made annually, semi-annually, or monthly, either at the end of the period or at the beginning. The present value of the remainder interest must be at least 10 percent of the value of the property contributed to the trust. When beneficiaries are young and payments are for their lives, this requirement may limit the payout rate to the 5- to 6-percent range. In addition, with a CRAT there cannot be a greater than 5-percent probability at the time of funding that trust assets will be exhausted before the trust ends. Rev. Rul. 77-374. This means that even if a CRAT has only one income beneficiary and even if the payout rate is only 5 percent, the so-called "5-percent-probability test" may not be passed if the beneficiary is relatively young and the trust lasts for the rest of his or her life.

C. Taxation of CRTs

A qualified CRT is exempt from federal income tax on all income, ordinary as well as capital gain, although any "unrelated business taxable income" earned by a trust is subject to a 100-percent excise tax.

D. Taxation of Payments to Income Beneficiaries

Income to beneficiaries is taxed under the following "four-tier" system, one which reflects a "WIFO" (worst-in, first-out) approach, at least within each tier:

First: Ordinary income to the extent payments consist of interest, dividends, and rents earned by the trust. Furthermore, ordinary dividends are deemed to be distributed before qualified dividends.

Second: Capital gain to the extent payments consist of capital gain realized by the trust. Furthermore, short-term capital gain is deemed to be distributed before long-term capital gain, and long-term gain taxed at higher rates is deemed to be distributed before long-term gain taxed at lower rates.

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Third: Tax-exempt income to the extent that the trust invests in tax-exempt securities and distributes interest from them.

Fourth: Tax-free return of principal.

To the extent not all first-, second-, or third-tier income received by the trust in a given year is distributed in the form of payments to beneficiaries for that year, the excess is carried forward for potential use in one or more subsequent years.

E. Tax Benefits of CRTs

1. Avoidance of tax on capital gain when appreciated property is transferred to the trust. The gain is taxed neither when the property is transferred to the trust nor subsequently when sold by the trust. Thus, the entire sales proceeds can be reinvested to generate income.

2. Income tax charitable deduction (*inter vivos* trusts) for the present value of the remainder interest. Usually the deduction is equal to 20 to 50 percent of the gift, though it could be as high as about 90 percent (albeit under the most unusual of circumstances) or as low as – but no lower than – 10 percent. (Technically, if the property contributed is short-term capital gain property or if there is some other reason that the nature of the property requires the deduction to be based on the cost basis of the property rather than on its fair market value, the deduction could be even lower than 10 percent, although the present value of the charitable remainder interest in the property would still need to be at least 10 percent of the fair market value of the property.) The amount of the deduction depends on (1) the nature and value of the property contributed, (2) the type of trust, (3) the payout rate (the higher the rate, the lower the deduction), (4) the duration of the trust, measured either by the lifetime(s) of one or more individual beneficiaries or the term of years the trust will continue to exist, if payable for a fixed term rather than life (the greater the duration, the lower the deduction), (5) the Sec. 7520 rate (the higher the rate, the higher the deduction, particularly for CRATs), and (6) the frequency and timing of the payments (the more often they are made, the lower the deduction, and the deduction is also lower if they are made at the beginning of the period than if they are made at the end).

If the trust instrument specifies that only public charities may be remainder beneficiaries of the trust, then the deduction may be used subject to the same percentage of adjusted gross income as would apply in the case of an outright contribution of assets to a public charity. If, however, the trust instrument even allows for the possibility that a private non-operating foundation could be a remainder beneficiary of the trust, then use of the deduction will be subject to the lower percentage of adjusted gross income applicable to an outright gift of assets to such a foundation.

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3. Gift tax and estate tax charitable deductions. The present value of a trust's remainder interest also qualifies for a gift or estate tax charitable deduction, as the case may be.

   If the trustor is the only income beneficiary of a trust, the entire value of the trust will be included in his or her estate at death, but the trustor's estate will be allowed an estate tax charitable deduction for the present value of the remainder interest passing to charity. This will result in no estate tax being payable on trust assets.

   If the trustor's U. S. citizen spouse is the only income beneficiary (or if such a spouse and the trustor are the only income beneficiaries), the spouse's income interest automatically qualifies for the gift or estate tax marital deduction. Again, no gift or estate tax will be payable on trust assets. (If the donor's spouse is not a U.S. citizen, some gift tax could be payable.)

   If the trustor is the sole initial beneficiary and is succeeded by one or more non-spousal beneficiaries, and the trustor has retained the right to revoke by will the interest(s) of the successor beneficiary(ies), the trustor will not have made a completed gift to that beneficiary (those beneficiaries) when the trust is created and will not have to pay any gift tax. The entire value of the trust will be included in the trustor's estate at death, but his or her estate will be allowed an estate tax charitable deduction for the present value of the charitable remainder interest.

   In most instances, if the trust is *inter vivos* and the trustor is not an income beneficiary, the trustor will have made a gift to the named beneficiary(ies) of the present value of the income interest. No part of the trust will be included in the trustor's estate but the gift, to the extent it exceeded the gift tax annual exclusion, will, like all taxable gifts, be added to the taxable estate.

   If the trust is testamentary, the trustor's estate will be entitled to an estate tax charitable deduction for the present value of the charitable remainder interest. The present value of the income interest will be subject to estate tax, to the extent the income interest benefits someone other than the surviving spouse of the donor.

   Note also: In the event the trustor names a "skip" person – for example, a grandchild – as income beneficiary of a CRT, the generation skipping transfer tax may apply.

F. Required and Optional Provisions in CRT Trust Instruments

The IRS has published Revenue Procedures 2003-53 through 2003-60 to update and expand its guidance on how to draft a trust instrument for a CRAT in such a manner that

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the trust will be a qualified CRAT. By means of Revenue Procedures 2005-52 through 2005-59, it did the same for CRUTs in 2005. For both types of CRTs, the revenue procedures address *inter vivos* and testamentary trusts established for a term of years, for one measuring life, and for two measuring lives (addressing further both the possibility that payments are made first to one person for life and then to the other person for life and the possibility that they are made on a joint-and-survivor basis). The guidance provided by the IRS in the various revenue procedures takes the form of sample basic wording for a trust instrument, sample optional wording, and certain annotations.

The IRS will recognize a trust as a qualified CRT meeting all of the requirements of the relevant portion(s) of IRC Sec. 664 if the trust operates in a manner consistent with the terms of the trust instrument, if the trust is a valid trust under applicable local law, and if the wording of the trust instrument is substantially similar to the sample basic wording set forth in the appropriate revenue procedure (with the wording for any alternative provisions likewise reflecting the sample optional wording set forth in the appropriate revenue procedure). A trust instrument that contains substantive provisions in addition to those found in the appropriate revenue procedure (other than those necessary to establish a valid trust under applicable local law that are not inconsistent with pertinent federal tax requirements), or that omits any provision found in the appropriate revenue procedure, will not necessarily be disqualified, but neither will it be assured of qualification under the provisions of the appropriate revenue procedure.

So long as one of the revenue procedures addresses the scenario in question, the IRS generally will not issue a letter ruling on whether the trust qualifies as a CRT. For example, because there is no revenue procedure addressing a trust lasting for three lives, the IRS might be willing to issue a letter ruling on whether a given three-life trust is a qualified CRT, although it should also be possible for a suitable trust instrument to be drafted by drawing upon elements of revenue procedures that address other scenarios. Nevertheless, the IRS generally will issue letter rulings concerning the effect that substantive trust provisions (other than those contained in the appropriate revenue procedure) will have on the qualification of a trust as a CRT.

Included among the required provisions are the following:

1. Even though the trust is irrevocable, the trustee must have the power to amend the trust instrument for the sole purpose of ensuring that the trust continues to qualify as a CRT.

2. The taxable year of the trust must be the calendar year.

3. The prorating of trust payments for short taxable years (usually, these will be the first and last years the trust is in existence) must be addressed.

4. Similarly, the possibility that trust assets might be valued incorrectly at one or more relevant points during the trust's existence must be addressed.

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5. The trust must be prohibited from engaging in certain transactions that would violate specific private foundation rules.

6. The trust instrument must ensure that when the trust terminates, the remainder will benefit only one or more qualified charitable organizations.

7. The trustee cannot be restricted from investing trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of such assets.

8. In the case of CRUTs, procedures must exist for dealing with any additional contributions of assets that may be permitted, and the valuation of "unmarketable assets" (i.e., anything other than "cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents") must be addressed.

9. If there is more than one income beneficiary or if the donor is not an income beneficiary, the trust instrument must state that no death taxes can be paid with trust assets, and that a beneficiary's interest will be valid only if such taxes are paid from sources other than the trust.

Permissible optional provisions for which the IRS has provided sample wording include the following:

1. A qualified charitable organization may be named to receive part – but not all – of the amount paid by the trust each year.

2. As an alternative to terminating once all individual beneficiaries have died or at the end of a period of no more than 20 years, the trust may terminate sooner if any of certain qualified contingencies occurs.

3. The trustor(s) may reserve the power to change the charitable remainder beneficiaries and the percentages of the remainder passing to each.

4. The trustor(s) may reserve the right to revoke by will an income beneficiary's interest in the payments made by the trust.

Furthermore, various rulings made over the years have confirmed that certain additional optional provisions, such as the following, are permissible even though the IRS has not necessarily provided pertinent sample language:

1. The trust instrument may permit – but not require – trust assets to be invested in particular ways.

2. A trustor may be named as a trustee (See Rev. Rul. 77-285, 1977-2 CB 213), although any power to apportion trust payments among beneficiaries

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must reside in a trustee independent of the trustor. Note: The IRS has provided sample language with respect to such a power to apportion.

3. The trust instrument may permit an acceleration of distributions to remainder beneficiaries.

4. The trust instrument may, subject to applicable state law, define income to include realized capital gain.

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