Giving Through Charitable Remainder Trusts

A charitable remainder trust is a trust that provides for a specified distribution, at least annually, to a minimum of one noncharitable income recipient for a period specified in the trust instrument, with the remainder interest paid to one or more charitable beneficiaries.

Charitable Remainder Trusts

The Tax Reform Act of 1969 provided tax benefits for several types of qualified charitable remainder trusts. See IRC section 664 for definitions.

There are two basic types of qualified charitable remainder trusts: the annuity trust and the unitrust. Both must qualify as valid trusts under applicable local law, and both must meet other specific requirements. Annuity or unitrust payments may be paid to the donor annually, quarterly, or at other intervals.

Annuity trusts: A charitable remainder annuity trust pays out each year a fixed dollar amount, at least 5% and not more than 50% of the initial fair market value of trust assets. The annuity payments are paid first out of income and then, to the extent necessary, out of principal, subject to the "four-tier" rules. Trust income in excess of the required annuity payout must be accumulated and added to principal or be distributed to a qualified charity. See IRC section 664(d)(1).

Unitrusts: A charitable remainder unitrust pays out each year an amount generally equal to a fixed percentage —at least 5% and not more than 50%, as selected by the donor—of the value of trust assets for that particular year. The trust assets are commonly valued, as directed by the trust agreement, on the first business day of each taxable year. A unitrust may also be designed to pay out whichever is less—its net income for the year or the specified fixed percentage amount. This is commonly called a "net income" unitrust.

With a net income unitrust, the trust agreement may provide that for years in which trust net income exceeds the specified unitrust amount, the excess income may be used to "make up" for past years in which trust net income was less than the specified unitrust amount. This type of unitrust is known as a "net income unitrust with a make-up (or catch-up) provision." See IRC section 664(d)(2).

A net income unitrust (with or without a make-up provision) is ordinarily used when the charitable remainder trust is to be funded with unimproved real estate or another type of asset that produces relatively little or no income.

Another use for the net income unitrust with make-up provision is in retirement planning. The trust assets are invested voluntarily by the trustee in low-yield, high-growth assets during working years. At retirement, the gains are taken tax-free within the trust, and the trustee then invests the proceeds in higher-yield assets to fund retirement needs. Check for current regulations regarding this type of trust.

Flip unitrusts: Final IRS regulations issued in December 1998 allow for the creation of so-called "flip unitrusts"—trusts designed to start out as net income or net income with make-up unitrusts, which "flip" to become straight-payout unitrusts following some "triggering event."

The triggering event generally must be an event outside the control of the trustee or any other person. Permissible triggering events include marriage, divorce, birth, or death. The sale of an unmarketable asset is also a permissible triggering event. Impermissible triggering events include the sale of a marketable asset or a request from the donor or any other person or entity that the trust flip. The flip occurs as of the first day of the taxable year following the year in which the triggering event occurs. See Reg. section 1.664-3(a)(1)(i)(f).

Trustee: The donor can select an appropriate trustee. An individual or a corporate fiduciary having experience in the management of charitable remainder trusts may be a good choice. The donor, with certain limitations, may name himself or herself as trustee.

Reformation of defective trusts: In the Tax Reform Act of 1984, Congress established a procedure by which many defective charitable remainder trusts, which would not otherwise qualify for favorable tax treatment, may be reformed and transformed into qualified trusts. See IRC section 2055(e)(3).

Specimen provisions: To aid drafters of charitable remainder trust agreements, the Internal Revenue Service has issued specimen provisions to be included in such agreements. Many of these can be found in the August 2003 Internal Revenue Procedure 2003-54 which contained eight new charitable remainder annuity trust specimen documents (Rev. Proc. 2003-53 through Rev. Proc. 2003-60). In 2005, the IRS released eight new

charitable remainder unitrust specimen documents (Rev. Proc. 2005-52 through Rev. Proc. 2005-59).

Charitable remainder trust for a term of years: An annuity trust or unitrust may be set up for a specified number of years (not to exceed 20). See IRC section 664(d). It is possible to establish a trust for one or more lives or a period of time up to 20 years, whichever is a longer, or shorter, period of time. It is not possible to provide for a trust to last for the life of one or more individuals plus 20 years.

Tax considerations: When a qualified charitable remainder trust is created, a current tax deduction is allowed for the value of the charitable remainder interest (except in certain situations involving funding the trust with tangible personal property). See IRC section 170(a)(3). The method of computing the deduction is described in Reg. section 1.664-4.

The Taxpayer Relief Act of 1997 added the requirement that the initial present value (as determined under IRS guidelines) of the charitable remainder interest be no less than 10% of the value of the assets contributed to fund the trust. The IRS had previously determined that no deduction would be allowed if it determined that the terms of a trust would lead to a 5% or greater probability that the trust assets would be exhausted prior to the termination of trust. The so-called “5% probability test” is laid out in Rev. Ruling 77-374.

If an individual establishes a charitable remainder trust for his or her life only, the trust assets will be included in his or her gross estate under IRC section 2036. The amount included, however, will “wash out” as an estate tax charitable deduction under IRC section 2055. A surviving spouse’s interest in a qualified charitable remainder trust qualifies for the estate tax marital deduction. See IRC section 2056(b)(8). Note that the marital deduction is lost if there is any non-charitable beneficiary of the trust other than the donor and the donor’s spouse.

Assets sold by a charitable remainder trust are exempt from capital gains tax, as the trust itself is a tax-exempt entity (except as to any unrelated business taxable income for the year). This can be very advantageous for donors who wish to fund such a trust with highly appreciated, low-yielding assets. The trust will retain the entire net proceeds of the sale of such assets, which can then be reinvested in higher-yielding investments.

There is a four-tier system of attributing ordinary income, capital gain, tax-free income, and corpus to the trust payout. See IRC section 664(b).

This provision may be very favorable in instances where appreciated assets have been used to fund the trust, as distributions deemed to be trust corpus will be reported by the donor as capital gains income until all capital gain realized by the trust has been “paid out.” This is especially attractive to donors who pay tax on capital gains at significantly lower rates than the tax on other income.

Under the four-tier system, it can be possible to report dividend income from a charitable remainder trust at lower tax rates than would be payable on other ordinary income. In addition, income earned by a charitable remainder trust from tax-exempt bonds can be received free of tax by a trust beneficiary.

Recipients of income from a qualified charitable remainder trust should seek guidance from the trust fiduciary and/or their tax advisor when reporting income from this source.

Mortgaged property: In Letter Ruling 9015049 (January 16, 1990), the IRS ruled privately that a trust cannot be a qualified charitable remainder trust if any trust income (which includes realized capital gain) is used to pay a mortgage debt on which the donor is personally liable. There are, however, ways to use property subject to such a mortgage to establish a charitable remainder trust. The most obvious way is for the donor to pay off the mortgage before transferring the property to the trust.

Testamentary trusts: Some people use trusts in their wills to provide income for a survivor. In the case of a life interest left to a spouse followed by a charitable disposition of the property, a combination of the charitable deduction and the marital deduction will effectively eliminate all tax at the federal level. See IRC sections 2523(a) and 2056(a).

Wealth Replacement Trust

A common technique that can be used in connection with charitable remainder trusts is for the donor to replace the asset he or she gives away using life insurance on his or her life.

The insurance can be purchased using the income received from the gift plan, the immediate tax savings generated by the gift plan, or some combination of both. In many cases, the life insurance is owned by, and payable to, an irrevocable insurance trust—a so-called “wealth replacement” trust. This can help ensure that the insurance proceeds will be free from estate taxation.

The tax code and regulations governing charitable remainder trusts change frequently. Check for new

developments before completing such arrangements.

General Tax Information

Charitable gifts of cash and “cash equivalents” may be deducted in one year up to 60% of a donor’s adjusted gross income and 100% for tax year 2021. The limit is 30% of adjusted gross income for gifts of long-term appreciated property.

Gift amounts in excess of these limits may be deducted in as many as five succeeding tax years. See Internal Revenue Code section 170(d)(1)(A).

When a gift plan is funded with an appreciated asset (securities or real estate, for example) held long-term (more than one year), the donor generally receives a charitable deduction based on the current fair market value of the asset.

If the appreciated asset consists of tangible personal property that the organization does not use in a manner related to its exempt purposes, the deduction will be limited to the asset's basis. See IRC section 170(e)(1)(B).

For further reading, see also from the Planned Giving Design Center:

Technical Reports:

- Charitable Remainder Trusts

Case Studies:

- Combining Charitable Lead and Remainder Trusts to Create a Temporary and Permanent Endowment
- Using the Charitable Remainder Trust to Simulate a Charitable Lead Trust
- Using a Term of Years CRAT to Make a Significant Near Term Gift
- A Charitable Remainder Unitrust for a Troublesome Asset
- Selling a Closely-Held Corporation with a Charitable Remainder Unitrust
- The Unplanned CRT: Promises Made

Articles:

- The Coming Boom In Charitable Trusts
- Funding A Charitable Remainder Trust With Encumbered Property
- Charitable Remainder Trusts and Depreciation Passthrough
- Charitable Remainder Trusts and the Section 170(c) Drafting Trap
- An Elegant Solution to Rev. Proc. 2005-24 Spousal Election Tax Trap
- Not Your Typical CRT - The Venture Capital Unitrust

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