Charitable Remainder Unitrusts

The Charitable Remainder Unitrust ("CRT") can be an effective means for diversifying highly appreciated assets while avoiding or postponing capital gains tax, increasing cash flow during your lifetime, obtaining a current income tax deduction and providing for your favorite charities upon your death. The concept is extremely simple: you transfer a highly appreciated asset to a trust, retaining the right to receive payments from the trust for your life. On your death, the charities you wish to benefit receive the assets remaining in the trust. The trust is included in your taxable estate, but qualifies for the estate tax charitable deduction.

HOW THIS TECHNIQUE WORKS

The tax advantages of the CRT come primarily from its tax-exempt status, which allows the trust to sell appreciated assets without paying any capital gains tax, and from the income tax deduction generated when you fund the trust.

Your income tax deduction for funding a CRT is limited to the present value of the charity's right to receive the assets remaining in the trust at your death. If you fund the CRT with assets that, if sold by you, would generate a long-term capital gain, your income tax deduction generally will be calculated using the fair market value of the appreciated assets. Nevertheless, you will not be required to recognize any gain when you fund the trust, either for regular income tax or for AMT purposes. If your CRT will benefit a private foundation, then your deduction will be calculated using your basis in the assets contributed to the CRT unless you fund the CRT with "qualified appreciated stock" (basically, unrestricted publicly traded securities). There are "percentage limitation" rules that limit how much of your adjusted gross income can be sheltered from income tax in any year with a charitable deduction. Excess deductions can be carried forward for up to five years. It is important to work with your accountant to confirm the actual tax benefits that can be achieved by funding a CRT with a particular asset.

The value of the charitable remainder interest in the CRT must be at least 10% of the value of the assets contributed to the trust. The value of the charitable interest is a function of (i) the length of time that payments will be made to you; (ii) the percentage of the trust assets that will be distributed to you each year, and the frequency with which payments will be made during the year (monthly, quarterly, semi-annually, or annually); (iii) the fair market value of the property being contributed to the trust at the time of the contribution; and (iv) the current IRS actuarial tables and interest rates used to calculate future values. See Table I at the end of this memorandum for an example of how these factors affect the value of the deductible gift.

TERMS OF THE CRT TRUST AGREEMENT

The CRT trust document may allow for the following:

- The trust would make distributions to you for life, and upon your death, the remaining trust property would be transferred or held in further trust for one or more U.S. charities.
- During the term of the CRT, you would receive a set percentage (at least 5%, but not more than 50%) of the fair market value of the trust's assets, as redetermined each year (the "unitrust amount"). The unitrust amount must be paid in accordance with the terms of the trust, that is, in monthly, quarterly or semi-annual installments, or annually. The CRT may not make any other distributions to you.
- When you receive the unitrust amount, it will be taxable to you under the Four Tier system applicable to CRTs, which treats the unitrust amount as paid first from the trust's ordinary taxable income (from the current year and any undistributed ordinary taxable income from prior years), next from the trust's net capital gains (current and prior years), and then from the trust's tax-exempt income. If the amount distributed to you exceeds all the trust's current and previously undistributed income and gains, the excess will be a tax-free return of principal.

- You can be the sole Trustee of your CRT. If your CRT holds assets that are difficult to value (restricted stock, closely-held stock, real estate, partnership interests), you must either appoint an Independent co-Trustee to value those assets each year or obtain a qualified appraisal of the hard-to-value assets each year.

TAX IMPLICATIONS OF THE CRT

If you and/or your spouse are the beneficiaries of the CRT, the objective is to diversify highly appreciated assets in a tax-efficient manner and to secure an income tax deduction for funding the trust. Your retained interest in the trust is not a taxable gift. If your spouse has an interest in the trust, then gift and estate tax deductions will be allowed for your spouse's interest as long as your spouse, or you and your spouse, are the only non-charitable beneficiaries and your spouse is a U.S. citizen. Gift and estate tax deductions also will be allowed for the charitable remainder interest in the trust.

If someone other than you or your spouse is the beneficiary of the CRT, the objective will be to benefit that individual with a stream of payments over the individual's life. The charitable remainder interest in the trust will reduce your taxable gift to the beneficiary of the CRT, but you will use gift tax credit and/or will pay gift tax on that gift. Because the CRT is a tax-exempt trust, the normal adverse consequences of using low basis assets to make a gift to someone are mitigated to some extent, and your income tax deduction for funding the CRT (and avoidance of recognition of gain when funding the CRT with low basis assets) may help to offset some of the gift tax cost of funding the CRT. When you use a CRT to make a taxable gift, it is important to structure the trust in a manner that will avoid having it included in your taxable estate should you predecease the beneficiary.

The CRT is a tax-exempt trust. However, it is extremely important for a CRT to avoid holding debt-financed property or other investments that produce unrelated business taxable income ("UBTI"). UBTI is subject to a 100% excise tax. The CRT should be able to avoid UBTI, and the confiscatory excise tax on UBTI, by investing in an unleveraged diversified portfolio of marketable securities. CRTs should avoid any borrowing and should be very cautious with respect to accepting gifts of and/or investing in mortgaged property, margin accounts, and partnerships and other pass-through entities that may produce UBTI for the trust.

The CRT's income and gains will be taxed to the beneficiary receiving the unitrust amount when and to the extent that the unitrust amount is treated as paid from the trust's income and gain. The CRT will keep a record of its undistributed income and gains. If the current year's ordinary taxable income is less than the unitrust amount, some or all of the prior years' ordinary taxable income that has not previously been distributed to the beneficiary will be treated as part of the distribution and will be taxed to the beneficiary. If the ordinary taxable income (current and prior years') is less than the unitrust amount, the CRT's current and prior years' undistributed capital gains will be treated as part of the distribution and will be taxed to the beneficiary. To the extent that the CRT produces ordinary taxable income, the capital gain realized by the trust from the sale of appreciated assets remains untaxed in the trust. In this way, the tax on the capital gain from the sale of appreciated assets you contribute to the trust is deferred and possibly avoided entirely.

COMMON QUESTIONS FROM CLIENTS WHO ARE EXPLORING THE POSSIBILITY OF CREATING A CRT:

Q: Who can be the beneficiary of the CRT?

A: Any individual can be a lifetime beneficiary of a CRT, as long as the value of the charitable remainder interest in the CRT is at least 10% of the value of the assets transferred to the trust.

Any individual, class of individuals (whether or not then living) or any entity (trust, corporation) can be the beneficiary of a CRT for a term of up to 20 years.

CRTs that are funded during the donor's life generally benefit the donor and/or the donor's spouse.

CRTs that are funded upon the donor's death often benefit the donor's spouse or children.

If there are multiple beneficiaries, their interests in the CRT may be successive interests or joint interests.

If a CRT benefits both the spouse and other family members, the spouse's interest will not qualify for the marital deduction for gift or estate tax purposes. In such cases, it may be preferable to create a marital trust for the spouse, followed by a CRT for the children, securing a marital deduction for funding the marital trust, and delaying and reducing the transfer tax to be paid at the spouse's death for the children's interest in the CRT.

Q: How long can the CRT last?

A: A CRT can last for the lifetime of a beneficiary or the lifetimes of multiple beneficiaries, or for a term of years (not to exceed 20), as long as the value of the charitable remainder interest in the CRT is at least 10% of the value of the assets transferred to the trust.

Q: Can you give me an example of the CRT tax calculations?

A: Looking at Table I, if a 60-year-old donor establishes a CRT to pay a 5% unitrust amount to himself for his life, and funds the CRT with appreciated marketable securities with a basis of $500,000 and a fair market value of $1,000,000, the value of the donor's deductible gift is $383,410. If the donor is age 75 at the time of the transfer, the value of the deductible gift is $603,470. The donor's retained interest in the CRT is not a gift for gift tax purposes. The gift of the charitable remainder interest is deductible for both gift and income tax purposes. In addition to the benefit of the income tax deduction, the donor defers and/or avoids paying tax on the $500,000 of capital gain that the CRT recognizes (but is not taxed on) when it sells the appreciated securities. The CRT will be included in the donor's taxable estate at his death with a fully offsetting estate tax deduction.

Q: Can I change the charitable remainder beneficiary after I fund the CRT?

A: If you are the beneficiary of the CRT, you may retain the right to change the charitable remainder beneficiaries by adding and removing charities, restricting how they will use the property to be distributed to them, and changing their relative shares in the remainder interest. If you are not the beneficiary of the CRT and you do not want to risk having the CRT included in your taxable estate, you should not retain the right to change the charities, but you may give that right to the beneficiary of the CRT.

Q: Can my private foundation be the charitable remainder beneficiary?

A: If you are a beneficiary of the CRT, you can name your foundation as the charitable remainder beneficiary without adverse transfer tax consequences. However, doing so may reduce the benefit of your income tax deduction for funding the CRT. The percentage limitation rules that determine how much of your adjusted gross income can be offset with a charitable deduction in any year are less favorable for gifts to private foundations, and unless your appreciated property gifts to the CRT are limited to "qualified appreciated stock," your income tax deduction for those gifts will be determined using your basis in the property rather than its fair market value.

If you are not a beneficiary of the CRT and want to avoid having the CRT included in your taxable estate, you should be cautious about naming your foundation as a remainder beneficiary unless you do not serve as a trustee, officer or director of your foundation or your foundation has adopted procedures that prohibit you from participating in decisions regarding the foundation's use of funds received from the CRT.

Q: Does a CRT have to pay me a unitrust amount? What other payment options are there?

A: A CRT distributes to the beneficiary a set percentage of the fair market value of the trust's assets, as revalued each year (a "unitrust amount").

A charitable remainder *annuity* trust ("CRAT") pays a fixed amount (a stated dollar amount or a percentage of the initial value of the CRAT) to the beneficiary each year.

A CRT also may pay the beneficiary the lesser of the trust's income and the unitrust amount (an "income CRT"). Since a CRT must make each payment to the beneficiary in a timely manner, an income CRT can be useful when the property that will be used to fund the CRT is illiquid and does not produce sufficient income to pay the unitrust amount as it comes due. An income CRT also may convert to a regular CRT upon the happening of a stated event, such as the sale of the illiquid asset, thereafter paying the beneficiary a fixed percentage of the value of the trust's assets, without regard to the amount of income produced by the trust.

Q: Can I make additional contributions to the CRT?

A: You may make additional contributions to a CRT. You will be entitled to an income tax deduction for the value of the charitable remainder interest in the additional assets contributed, and to an increased unitrust payment based on the amount added. Before funding the CRT or making any additional contribution, you need to confirm that the value of the charitable remainder interest will be at least 10% of the value of the assets being contributed to the trust.

You may not make additional contributions to a CRAT.

Q: Is there a way for me to use a CRT to diversify my low basis assets in a tax-efficient manner without "disinheriting" my family?

A: If you and/or your spouse are insurable, you can create an irrevocable trust to purchase and own a policy of insurance on your life or on the joint lives of you and your spouse. You would use a portion of the CRT distributions to fund the premium payments for the trust. On your death or on the death of the survivor of you and your spouse, the assets remaining in the CRT would pass to charity and the insurance would be paid to the trust for the benefit of your descendants. If properly structured, the insurance trust and policy would not be included in your taxable estate.

Q: What are the costs of administering a CRT?

A: Depending on who serves as trustee and handles the investment of the trust's assets, the CRT might have to pay trustee fees and/or investment management fees. The trustee must file an information return for the trust each year, and must prepare a Schedule K-1 informing the beneficiary how to report the unitrust payments for income tax purposes. Usually no court costs or court supervision are involved during the beneficiary's life. Some states (for example, New York) require a court accounting to be filed after the interests of the non-charitable beneficiaries expire. There also are costs involved in establishing the trust, such as fees to prepare the trust agreement and gift tax return.

Q: What property should I use to fund a CRT during life? What property should I use to fund a CRT at death? What property should I not use?

A: Generally, funding a CRT during life with low basis assets that if sold would produce a long-term capital gain will produce the greatest benefit for the donor. If the CRT will benefit a private foundation, it is generally preferable to fund the CRT with qualified appreciated stock (unrestricted publicly traded securities that if sold would produce a long-term capital gain).

When funding a CRT at death, it may be advantageous to use assets that are subject to income tax, such as a retirement account.

You should avoid funding a CRT with mortgaged property, property in which you will continue to own an interest (property that you would own with the CRT as tenants in common), interests in partnerships that hold debt-financed property or that operate an active trade or business, S corporation stock, assets that are subject to a binding sales contract or any agreement or understanding under which the trustees of the CRT would be obligated to sell the property to a third party, and during your life, retirement accounts and other assets that would cause you to recognize ordinary income if you transferred them to the trust. Illiquid assets, life insurance policies, options, and tangible personal property also may present issues.

It is advisable to work with your attorney and your accountant to confirm that your plans for funding a CRT will produce the desired results both with respect to the income tax consequences of your gift and with respect to the administration of and tax consequences to the CRT.

TABLE I

Deductible gift if $1,000,000 is transferred to a Charitable Remainder Unitrust paying 5%, 6% or 7% per year in quarterly installments, assuming an IRS interest rate of 3.4%. (Changes in the IRS interest rate have little effect on unitrusts. Table II illustrates how they affect annuity trusts.)

AGE OF BENEFICIARY	5% Payout	6% Payout	7% Payout
50	$ 265,890	$ 211,790	$ 170,980
55	$ 321,240	$ 263,950	$ 219,230
60	$ 383,410	$ 324,310	$ 276,600
65	$ 451,310	$ 392,060	$ 342,680
70	$ 525,500	$ 468,260	$ 419,080
75	$ 603,470	$ 550,590	$ 503,850

TABLE II

Deductible gift if $1,000,000 is transferred to a Charitable Remainder Annuity Trust paying $50,000 per year in quarterly installments, assuming an IRS interest rate of 3.4%, 5.4% or 7.4%. (Compare the deduction for funding a unitrust with a 5% payout — see the left column above under 5% Payout). An annuity trust must satisfy a 5% probability test. When the IRS interest rate is below the annuity trust's payout rate, the risk of failing the test increases (see the left column below under 3.4% IRS rate for beneficiaries under age 65).

AGE OF BENEFICIARY	3.4% IRS rate	5.4% IRS rate	7.4% IRS rate
50	Not Permitted	$ 293,520	$ 423,700
55	Not Permitted	$ 345,200	$ 457,080
60	Not Permitted	$ 403,660	$ 496,830
65	$ 370,380	$ 467,920	$ 542,640
70	$ 465,840	$ 538,610	$ 595,660
75	$ 562,540	$ 613,390	$ 654,540

As the IRS interest rate approaches the payout rate in an annuity trust, the deduction is approximately the same as it would be for a unitrust having the same payout rate. As the IRS interest rate falls below the payout rate in an annuity trust, a unitrust provides a better deduction, and as the IRS interest rate increases over the payout rate in an annuity trust, an annuity trust provides a better deduction.

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This document is intended to convey to you the principal characteristics of Charitable Remainder Unitrusts as they apply to common situations. For this reason we have deliberately simplified technical aspects of the law in the interest of clear communication. Under no circumstances should you or your other advisors rely solely on the contents of this document for technical advice nor should you reach any decisions with respect to this topic without further discussion and consultation with a Cummings & Lockwood attorney.

In accordance with IRS Circular 230, we are required to disclose that: (i) this memorandum was not intended or written by us to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer; (ii) this memorandum was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the memorandum; and (iii) each taxpayer should seek advice on his or her particular circumstances from an independent tax advisor.