

PROFESSIONAL TAX & ESTATE PLANNING NOTES

June 2008

Charitable Remainder Unitrusts

In our March 2008 issue of *Professional Notes*, we explained that charitable remainder trusts (CRTs) are arrangements that provide for the eventual transfer of property to charity after paying income to one or more non-charitable beneficiaries for a period of time. They are strictly defined under the Internal Revenue Code and Treasury Regulations.¹

A charitable remainder unitrust (CRUT) is a CRT that makes annual payments to the income beneficiaries as a fixed percentage of its annual value. The unitrust amount will increase or decrease from one year to the next with the trust's market value. To the extent that property in the trust appreciates in value over time, a

unitrust provides a hedge against inflation for the income beneficiaries.

The March 2008 issue also described CRTs as extremely flexible estate and financial planning tools for many individuals and businesses. They provide 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 upon the disposition of appreciated assets; and
- exemption from tax of earnings of the trust until they are distributed to the income beneficiary.

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¹All "Code" references are to Sections of the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. Section" references are to regulations thereunder.

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Basic Requirements

The term of a charitable remainder unitrust, like the charitable remainder annuity trust, must be measured by the lifetime of the beneficiary, or for a term not to exceed 20 years. The payout rate of a CRUT must be at least five percent and may not exceed 50 percent.

The law also requires that the present value of the charitable remainder must be at least 10 percent of the fair market value of trust assets, measured when the trust is created. This rule was implemented because short-term, net income make-up unitrusts with payout rates as high as 80 percent were being used to transform highly appreciated assets into cash while avoiding gain, with little going to charity.

Unfortunately, some taxpayers may inadvertently run afoul of the 10 percent charitable remainder rule, particularly if 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 the use of formula clauses or giving the trustee the power to decide whether to amend the trust or declare it void.

Unlike a charitable remainder annuity trust, a donor may make additional contributions to a charitable remainder unitrust, if authorized by the trust instrument. If additional contributions are permitted, the trust instrument must contain certain provisions for the calculation of the unitrust amount payable in the event additional contributions are made, which are found in Section 1.664-3(b) of the Treasury Regulations. All additions to a unitrust must meet the 10 percent charitable remainder rule.

The Internal Revenue Service has published model forms of charitable remainder unitrusts, both *inter*

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vivos and testamentary, in Revenue Procedures 2005-52 – 2005-59.

Variations on the Charitable Remainder Unitrust

In addition to the standard form of unitrust, there are two important variations that are widely used.

The first of these is the *Net Income Charitable Remainder Unitrust*, which provides for an annual payment equal to the lesser of the unitrust amount or actual income (using fiduciary accounting income as determined under local law). The net income trust often is drafted to provide for a “make-up” provision, so that if trust income is lower than the fixed percentage in one or more years and is higher in a subsequent year, the shortfall may be paid to the beneficiary at the later time.

The net income CRUT is a good choice for assets that may not be readily marketable, and it sometimes is used to replace or supplement conventional retirement plans. Because the yearly payments are limited to income, these CRUTs may be invested to emphasize capital appreciation in the trust, minimizing income until the income beneficiary needs it. When income has been less than the unitrust percentage, a large base is preserved in the trust from which later unitrust payments will be made. The Internal Revenue Service has indicated that efforts to control the recognition of income by a net income CRUT in order to manipulate the flow of distributions to the annuitant may constitute an act of self-dealing subject to excise taxes, so special care should be taken. (See PLR 9643014 and IRS Training Manual, “1996 Exempt Organizations CPE Technical Instruction Program Textbook.”) There has been no further guidance since 1997 when the IRS announced that it was studying this issue and would not issue any further private rulings. (See

Revenue Procedure 97-23, 1997-1 C.B. 654; Revenue Procedure 2008-3, 2008-1 I.R.B. 110, Sec. 4.01 (37).)

Another form of CRUT, a so-called *Flip Trust*, starts out as a net income CRT and changes to a “standard” unitrust during the term of the trust. Because it starts out as a net income CRT, the flip trust may be particularly advantageous for unmarketable assets that do not generate substantial income. Once the unmarketable assets are disposed of by the trust, it flips to a standard unitrust, and the assets can be invested for total return without regard to the income yield.

Under Treas. Reg. Section 1.664-3(a)(1)(i)(c), a charitable remainder unitrust may provide for a flip if the flip is triggered “on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons.” Such events, which must be set forth in the trust agreement, could include the sale of unmarketable assets, marriage, divorce, or the birth of a child. The conversion date must be the beginning of the taxable year immediately following the year containing the triggering event. Any “make-up” amount is forfeited upon the conversion.

If a unitrust has a net income feature, the trust instrument may treat certain realized capital gains as fiduciary accounting income if allowed by state law and permitted by the trust instrument. (See Treas. Reg. Section 1.664-3(a)(1)(i)(b)(3).) In the case of a net income unitrust with a make-up provision, this can be a useful technique if the trust assets are invested in appreciated property that has not produced sufficient annual income to satisfy the unitrust amount. However, the Treasury Regulations provide that any pre-contribution capital gain realized on the sale of the assets originally transferred to the trust must be

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allocated to principal. In addition, for taxable years ending after January 2, 2004, proceeds from the sale or exchange of assets purchased by the trust must be allocated to principal, at least to the extent of the purchase price paid by the trust.

Other Considerations

Valuation

Unlike a charitable remainder annuity trust, a charitable remainder unitrust requires an annual valuation of the fair market value of the trust assets in order to calculate the unitrust amount. If the assets held in the trust do not have a readily available market price, an appraisal will be needed during each year of the trust. The potential cost of such annual appraisals should be considered in deciding whether to create a unitrust.

Taxation of Distributions

As discussed in the March 2008 issue, income beneficiaries will be subject to tax on distributions from a CRT based on a tier system, which classifies distributions from the trust as ordinary income, capital gain, or return of principal, depending on the character of the income earned by the trust.

Waiver of Spousal Right of Election

Under New York law, as in a number of other states, and unless there is an enforceable agreement to the contrary, a surviving spouse has a right of election that may entitle him or her to as much as 50 percent of the decedent’s assets. As discussed in the March 2008 issue, in Rev. Proc. 2005-24 the IRS advised that if a donor retains a life interest in a CRT, the mere existence of a spousal right of election that could be applied against the property in the CRT, whether or not exercised, would cause the CRT to fail to qualify under IRC Section 664(d) unless the right of election were to be waived. Even though the IRS subsequently suspended this Revenue Procedure, the right of

election is still a planning consideration. To avoid unintended consequences to estate plans, advisors may wish to recommend that the non-contributing spouse waive his or her right of election to a charitable remainder trust at the time the trust is created.

Excise Tax on Self-Dealing

Charitable remainder trusts are subject to many of the private foundation rules, including the prohibition on self-dealing contained in Section 4941 of the Code. Section 4941 imposes a punitive excise tax on the amount involved in certain acts of self-dealing between the private foundation (in this case, the CRT) and “disqualified persons,” who would include the trustees, the donor, and certain family members. The tax is payable by the disqualified person who engages in the act of self-dealing and, in some cases, by the participating “foundation managers” (i.e., the trustees, in the case of a CRT). The tax on the disqualified person is 10 percent of the amount involved, but if the act of self-dealing is not corrected, there is a second tax of 200 percent of the amount involved. The tax on the “foundation manager,” in this case the trustee of the CRT, is 5 percent of the amount involved and 50 percent if not corrected, capped at \$20,000.

With certain exceptions, acts of self-dealing may include: (1) the sale, exchange, or lease of property between a CRT and a disqualified person; (2) the lending of money or other extension of credit between a CRT and a disqualified person; (3) the furnishing of goods, services, or facilities between a CRT and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a CRT

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 income tax, the gain on the sale by the trust of these assets will be free from tax (except to the extent distributed in the year the gain is received).

to a disqualified person (other than reasonable compensation for necessary services); and (5) the transfer to, or for the benefit of, or use by, a disqualified person of the income or assets of a CRT. The Section 4941 excise taxes described above apply to all self-dealing activities, even if the activities ultimately benefit the charity. Consequently, all transactions between a CRT and disqualified persons should be carefully scrutinized to ensure that they do not constitute self-dealing.

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 income tax, the gain on the sale by the trust of these assets will be free from tax (except to the extent distributed in the year the gain is received). As a word of caution, the IRS has, in certain circumstances, imputed the gain directly to the grantor, such as where the trustees had an express or implied obligation to sell the transferred property.

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 persons other than a spouse may benefit from the retirement plan assets.*

*This subject is discussed in detail in the October 2004 issue of *Professional Notes*.

Tangible personal property.

Valuable tangible 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. As explained above, because tangible personal property does not produce income, a net income CRUT or a flip trust may be an appropriate choice to hold tangible personal property.

Selecting the Charitable Remainder Beneficiary

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 flexibility of The New York Community Trust makes it an ideal remainder beneficiary. The Trust offers four types of charitable funds. For people who want to contribute to the vitality of their communities, an unrestricted fund provides maximum flexibility. For those with a particular area of concern, such as education or health, a field-of-interest fund may be the perfect vehicle. Donor-advised funds allow donors to recommend nonprofits they wish to benefit, and designated funds allow a donor to specify one or more institutions to benefit, subject to The Trust's variance power.

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When The New York Community Trust is the beneficiary of a CRT for an unrestricted or field-of-interest fund, or for a donor-advised fund where principle may not be expended, we will consider serving as trustee. Please contact us to discuss whether our involvement as trustee would be appropriate.

For further reference, see:

Code Section 170(a)(3): Gift of future interest in tangible personal property.
Code Section 170(f)(2): Gifts of split interests in property.
Code Section 664: Charitable remainder trusts.
Code Section 2055(e): Bequests of split interests.
Code Section 2522(c): Gift tax deduction for charitable gifts.
Code Section 4941: Excise tax on acts of self-dealing.
Treasury Regs. Sec. 1.664-1(d)(1): Character of distributions from CRTs.
Treasury Regs. Sec. 1.664-3(a)(1)(i)(c): Flip trusts.
Treasury Regs. Sec. §1.664-3(a)(1)(i)(b)(3): Treatment of capital gain as income.
Treasury Regs. Sec. 1.664-3(b): Additional contributions to unitrusts.
Revenue Procedure 97-23, 1997-1 C.B. 654
Revenue Procedure 2005-24, 2005-1 C.B. 909
Revenue Procedures 2005-52, 2005-2 C.B. 326 to 2005-59, 2005-2 C.B. 412
Revenue Procedure 2008-3, 2008-1 I.R.B. 110, Sec. 4.01 (37)
Private Letter Ruling 9643014.
IRS Training Manual, "1996 Exempt Organizations CPE Technical Instruction Program Textbook."
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.

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