

# CHARITABLE REMAINDER TRUST HANDBOOK



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# Charitable Remainder Trust Handbook

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## Introduction

A Charitable Remainder Trust (CRT) is an irrevocable agreement in which a donor transfers assets to a trust in exchange for an income interest<sup>1</sup>. A qualified CRT is exempt from income tax, allows the donor to claim an income tax charitable deduction, permits the tax-free sale of appreciated assets and irrevocably designates the remainder for the benefit of one or more charitable beneficiaries, including public charities, donor-advised funds, and private foundations.

## Parties to a Charitable Remainder Trust

In its most basic form, a charitable remainder trust consists of an arrangement between four parties: 1) a donor; 2) a trustee; 3) an income beneficiary; and 4) a charitable remainder beneficiary. As discussed below, it is possible for the donor, trustee, and income beneficiary to be the same person. The donor enters into a trust agreement with the trustee to transfer certain assets to be managed and maintained by the trustee. In accepting the assets, the trustee agrees to pay an income stream to one or more designated income beneficiaries for the rest of their lives or a designated period of time. At the expiration of the trust term, the trustee delivers the remaining trust assets to the charitable remainder beneficiary. A unique feature of the CRT is that it is generally exempt from tax.<sup>2</sup>

**The Donor.** Any individual, corporation, partnership, limited liability company (LLC), or trust can be a donor.<sup>3</sup> An individual donor can create a CRT during life or at death. Transfers to a qualified CRT allow a donor to claim a charitable deduction for income, estate, gift, and generation-skipping transfer (GST) taxes.

**The Trustee.** The CRT trustee may be an individual, including the donor,<sup>4</sup> or an institution such as a bank or charity. When the donor serves as trustee, the donor can hire best-in-class service providers for investment management and CRT administration. This arrangement unbundles traditional trustee services of fiduciary decision-making, investment management, and CRT administration. Charities and

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<sup>1</sup> In some cases, the income interest may be designated to a person or persons other than the donor and the donor's spouse. See the section below titled "Gift, Estate, and GST Tax Considerations" for an overview of the gift tax implications of this choice.

<sup>2</sup> For an exception to the CRT's tax-exempt status, see IRC § 664(c)(2) and the discussion below on unrelated business taxable income.

<sup>3</sup> A sampling of PLRs that permit non-natural person entities to be a CRT donor includes: C-Corporation – 9205031 and 8102093; S-Corporation – 200644013 and 9340043; LLC – 199952071; Partnership – 9419021; and Trust – 9821029.

<sup>4</sup> See Revenue Ruling 77-285.

banks can utilize this same outsourcing approach for investment management and CRT administration.

**The Income Beneficiary.** In most CRTs, the donor and the donor's spouse will be named for their joint lifetimes as the only income beneficiaries of a CRT. Nevertheless, the Code and regulations permit any person<sup>5</sup> to be named as a CRT's income beneficiary so long as at least one income beneficiary is not a charitable organization.<sup>6</sup> For example, the income beneficiary could be an individual, corporation, partnership, LLC or trust. However, if any non-natural person beneficiary *could be* an income beneficiary, the payout length of that person's CRT interest may not exceed 20 years.

In addition, the donor may elect to include one or more charities as co-income beneficiaries.<sup>7</sup> This may be desirable when the donor wishes to currently benefit the charity and/or purposefully reduce the amount paid to the non-charitable beneficiary.

Occasionally, CRTs name an income beneficiary other than the donor and/or the donor's spouse. Designing such a CRT creates an array of complications in the design, drafting, investing, and administration of a CRT. These complications are discussed more fully below.

**The Charitable Remainder Beneficiary.** The charitable remainder interest in a CRT may benefit a public charity (e.g., the donor's alma mater, a religious institution, the United Way, etc.) or a privately-controlled charity (e.g., a private foundation). A third possibility is to split the remainder interest among several charities such as "2/3 to my alma mater and 1/3 to my private foundation."

In many CRTs, donors retain the power to change the charitable remainder beneficiaries.<sup>8</sup> The donor may choose to name a specific charitable remainder beneficiary immediately, defer the decision until later, name the charitable remainder beneficiary in their will, or grant that power to a child or friend. The donor's charitable goals should govern the selection and timing of naming the charitable remainder beneficiaries.

**The Heirs.** Often the seemingly neglected fifth party to a CRT is the donor's heirs. Because most CRTs are created for the benefit of the donor and the donor's spouse, without additional planning heirs are left out of the equation. This omission is easily remedied by using life insurance held in a Wealth Replacement Trust (WRT) to replace the assets transferred to the CRT.

Another option is to name the children as additional income beneficiaries of the CRT. This creates additional complications as noted above.

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<sup>5</sup> IRC § 7701(a)(1) defines a "person" as an individual, trust, estate, association, company, corporation and partnership.

<sup>6</sup> See IRC § 664(d)(1)(A) and Treas. Reg. § 1.664-2(a)(3)(1) for annuity trusts. See IRC § 664(d)(2)(A) and Treas. Reg. § 1.664-3(a)(3)(1) for unitrusts.

<sup>7</sup> See PLRs 9323039 and 200108035 for a discussion of some of the issues surrounding naming a charity as a CRT income beneficiary. If a charity is named as an income beneficiary, then the application of IRC §§ 4943 (excess business holdings) and 4944 (jeopardizing investments) must be required by the trust's governing instrument. IRC § 4947(b)(3).

<sup>8</sup> See Revenue Rulings 76-7 and 76-8.

## Charitable Remainder Trust Formats

There are a number of qualified CRT formats. The principal distinction among these formats is how the trust agreement defines the income interest. The trust must specify that the income interest will be paid as: (a) a fixed amount (a Charitable Remainder Annuity Trust, or CRAT)<sup>9</sup> or (b) a fixed percentage of the trust's assets revalued annually (a Charitable Remainder Unitrust, or CRUT).<sup>10</sup> The Code requires that these defined formats be used to receive the benefits of a qualified CRT.

Within the CRUT format there are three varieties:

- **Standard Charitable Remainder Unitrust (SCRUT).** As described above, a SCRUT must pay a *fixed percentage* of the trust's assets revalued annually.<sup>11</sup> Therefore, as the value of the trust's assets rises and/or falls on the annual valuation date, payments to the trust beneficiaries will rise and fall.
- **Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT).**<sup>12</sup> A NIMCRUT differs from a SCRUT in two key aspects. First, in determining the amount of the payments to the income beneficiaries, the trustee must compare the fixed percentage unitrust amount to the trust's accounting income<sup>13</sup> and pay the *lesser* of these two amounts to the income beneficiaries.<sup>14</sup> Second, for each year that the trust's accounting income is less than the unitrust amount, the difference (or deficiency) is accumulated as an amount that may be "made up" in the future<sup>15</sup> (i.e., the "make-up amount"). Payments of the make-up amount *must* be made to the extent that the trust's accounting income in any year exceeds the fixed percentage unitrust amount.
- **Flip Charitable Remainder Unitrust (Flip-CRUT).** The life cycle of a Flip-CRUT is generally characterized by two phases. In the initial phase, a Flip-CRUT acts like a NIMCRUT and only distributes the trust's accounting income to the income beneficiaries. In the second phase, following the occurrence of a predetermined triggering event, the trust switches, or "flips," to a SCRUT<sup>16</sup> and pays out a fixed percentage of the trust's annual fair market value. The trustee has only until the end of the tax year in which the triggering event occurs to make any payments pursuant to the make-up provision.<sup>17</sup> The

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<sup>9</sup> IRC § 664(d)(1)(A).

<sup>10</sup> IRC § 664(d)(2)(A).

<sup>11</sup> *Id.*

<sup>12</sup> Technically another variation is the **Net-Income Charitable Remainder Unitrust (NICRUT)**. Note that this version has no make-up provision. In the authors' experience most of the very few examples of this format were due to plan design and/or drafting errors. Nevertheless, valid uses of the NICRUT do exist.

<sup>13</sup> To determine a trust's accounting income, IRC § 43(b) specifies that the trustee look to state trust law. Most states have a "Principal and Income" statute that provides a set of default rules for determining whether a cash receipt or cash disbursement is allocated to trust income or trust principal. These rules often differ significantly from definitions of taxable income.

<sup>14</sup> See IRC § 664(d)(3) and Treas. Reg. § 1.664-3(a)(1)(i)(b).

<sup>15</sup> See IRC § 664(d)(3) and Treas. Reg. § 1.664-3(a)(1)(i)(b)(2).

<sup>16</sup> See Treas. Reg. § 1.664-3(a)(1)(i)(c).

<sup>17</sup> Treas. Reg. § 1.664-3(a)(1)(i)(c)(3).

change in the payout method commences on January 1<sup>st</sup> of the year following the triggering event.

Permissible triggering events<sup>18</sup> include:

1. The *sale of an unmarketable asset*;
2. A *date certain*;
3. The *birth* of any person;
4. The *death* of any person;
5. The *marriage* of any person;
6. The *divorce of any person*; or
7. An *event outside the control* of the trustees or any other persons.

## When Should Donors Consider a CRT

There are three principal situations where a CRT may be appropriate:

1. A donor is contemplating a transaction which will generate a significant tax liability;
2. A donor needs income now or in the future; or
3. A donor has charitable goals and interests to support.

These factors are not mutually exclusive and the greater degree to which each describes a donor, the more likely a CRT will be a satisfying solution.

Much of the power behind the CRT is based on its tax-exempt status and irrevocable nature. CRTs can be funded with a variety of assets including stocks, bonds, mutual funds, restricted securities, exchange traded funds, real estate in various forms, partnership interests, LLCs, C-corporations, art and other tangible personal property. When combined with an ILIT, the CRT can solve many of your donor's noncharitable problems within a charitable context.

A CRT can enable donors to realize charitable goals that seem beyond their reach. For example, making a current gift to endow a chair in the donors' name at their *alma mater* may be infeasible, but by utilizing a CRT, this goal can be brought within the donors' grasp.

## Thoughts on Unusual Funding Assets

Obviously, some assets work more compatibly with a CRT than others. For example, cash and publicly traded securities (that can be freely traded) work extremely well both as a gift to a CRT and as an investment by a CRT. On the other hand, gifts of real estate, partnership interests, LLCs and C-corporations require much greater analysis and may ultimately be a poor choice of asset as either a gift to or investment by a CRT. Thoughtful analysis should always include a review of whether the asset is encumbered by debt. In the case of partnerships and LLCs, their pass-through nature requires the

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<sup>18</sup> See Treas. Reg. § 1.664-3(a)(1)(i)(c)(1), (d).

attorney to review the debt characteristics inside the business as well as the actual business operations. Any debt on the contributed asset will reduce the client's income tax deduction, cause recognition of income due to the transfer, potentially make the CRT owe unexpected taxes and potentially turn the trust into a grantor trust. The same concern holds true for debt or certain business operations that occur within a partnership or LLC.

It is important to recognize that a gift of S-corporation stock will immediately terminate the subchapter S status of the S-corporation because a CRT is not an eligible shareholder under IRC § 1361(c). Nevertheless, some clients who own S-corporations do create CRTs. Most commonly, the S-corporation will create the CRT and fund it with assets which the corporation is ready to sell for a capital gain. In such a situation, the S-corporation is typically named as the CRT's income beneficiary, which means the non-charitable term is limited to a term that cannot exceed 20 years. Another rare possibility is for shareholder clients to transfer stock in the S-corporation to a CRT. For situations when this makes sense, the authors recommend that the S-corporation's board vote affirmatively to terminate the S status *before transferring* stock to the CRT. At the very least, by following this recommendation the board will be forced to consider the ramifications of terminating the S-election as opposed to an automatic, inadvertent termination that would occur if a shareholder simply transferred stock of an S-corporation to an ineligible shareholder. As a final note on this topic, CRTs cannot qualify as either a Qualified Subchapter S Trust (QSST) under IRC § 1361(d) or an Electing Small Business Trust (ESBT) under IRC § 1361(e).<sup>19</sup>

Gifts of restricted securities create another set of concerns. While securities can be subject to a myriad of restrictions, they typically involve some restriction on the transfer of title to the securities. In some cases, the restriction will expire a certain number of months after an initial public offering. In other cases, the restriction simply requires the shareholder to disclose any transfers. In other cases, the restriction does not limit a transfer but does limit the overall number of shares that can be traded within a narrow timeframe. As a result, the type of restriction must be reviewed carefully before contributing (or considering a contribution of) these assets.

Another possibility is employee options. There are two basic types of employee options. Qualified options (also called Incentive Stock Options or ISOs) require the holder to meet several tests. While an in-depth discussion of ISO planning is beyond the scope of this article, one of the tests to retain ISO status is that the shareholder/employee may not transfer the shares until more than one (1) year after the option is exercised. Also, the exercise of an ISO option creates Alternative Minimum Tax. This is a tax on phantom cash flow since cash is not actually generated when an ISO option is exercised. One strategy for working with ISOs is to exercise the option early in the tax year. If the share price drops after exercising the option, the employee can dispose of the stock near the end of the year in a disqualifying disposition. If the disposition is during the same year as the exercise, then the AMT issue is retained in the same tax year and may be eliminated. On the other hand, if the employee exercises the option near the

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<sup>19</sup> See Revenue Ruling 92-48.

end of the year, it will be harder for the employee to determine whether to purposefully disqualify the ISO status via an early disposition.

Assuming the employee has not disqualified the ISO status of the shares, then a transfer of the shares to a CRT (after various holding periods are met including waiting more than one (1) year after the ISO option exercise date) can provide considerable benefit to the client. These benefits are the same as for most other gifts of long-term capital gain assets including being eligible to claim an income tax charitable deduction, making a charitable gift, deferring capital gain taxation and providing a lifetime cash flow.

Non-qualified stock options (NQSOs) do not meet the statutory rules of ISOs. As a consequence, on exercise the grantee (usually an employee of the granting company) of a NQSO immediately recognizes ordinary income to extent the fair market value of the underlying stock exceeds the strike price on the date of exercise. Furthermore, because the spread between the strike price and the fair market value of the underlying stock is taxed, the owner of the stock immediately has basis in the stock equal to the fair market value of the stock on exercise. In addition, the tax obligation inherent in the NQSO is not transferable. Therefore, if NQSOs are transferred to a CRT and then subsequently exercised by the CRT trustee, any tax obligation arising from that exercise is the responsibility of the grantee (who is usually the donor).

Gifts of art and other tangible property to a CRT involve additional considerations. Generally, the income tax deduction for such gifts is limited to the client's cost basis in the property. Additionally, each piece of art or tangible property may require special handling while the CRT owns it such as insurance, shipping costs, temperature controlled rooms, etc. The expenses associated with such special handling may outweigh the benefits of contributing the art or tangible property to the CRT.

## Designing the CRT

**Select the Appropriate Payout Rate.** When selecting the payout rate for a CRT, it is important to keep several key points in mind. First, the annual payout rate of all CRTs must be between 5% and 50%.<sup>20</sup> Second, the payout rate is an integral part of the calculation of the actuarial present value of the remainder interest (APVRI).<sup>21</sup> For CRTs funded after July 29, 1997, the APVRI for qualified transfers to a CRT must be 10% or greater of the amount transferred.<sup>22</sup> This requirement also applies to additional contributions to all unitrusts.<sup>23</sup> Third, the payout rate selected should take into account the income beneficiary's current and future cash flow requirements. A payout rate greater than the actual investment return will cause *unitrust* payments to decrease with time. Fourth, the higher the payout rate, the lower the income tax deduction. Note that for the same payout rate, the deduction allowed for a SCRUT is equal to the deduction allowed for a NIMCRUT or Flip-CRUT. This is true despite the fact that the actual charitable remainder of a SCRUT is likely to be less than the actual charitable remainder of a NIMCRUT. This is discussed further below.

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<sup>20</sup> See IRC §§ 664(d)(1)(A), 664(d)(2)(A).

<sup>21</sup> The payout rate is a key factor in determining if a CRAT will pass the 5% probability test of Revenue Ruling 77-374.

<sup>22</sup> See IRC §§ 664(d)(1)(D) and 664(d)(2)(D).

<sup>23</sup> CRUTs may be drafted to permit additional contributions, but CRATS may not.

**Match the CRT Format to the Income Beneficiary's Needs.** The range of payout rates that satisfies all the requirements for qualification is only the jumping off point in designing the CRT. The CRT format selected has a significant impact on the amount and regularity of the income beneficiary payments. For example, if the SCRUT format is selected, the annual payments will vary in amount as the trust value fluctuates, but must be made regardless of trust's income. If the NIMCRUT format is selected, the annual payments will vary in amount and may cease altogether if the trust does not receive income.

If the CRAT format is selected, payments of the same amount will occur like clockwork. For older income beneficiaries, this level payment stream is attractive, but the longer the trust term, the more the purchasing power of each payment is eroded by inflation. If the SCRUT format is selected, then it is possible for payments to increase each year—thereby keeping pace with inflation.<sup>24</sup> If the NIMCRUT or Flip-CRUT format is selected, then it is possible to create an accumulation phase followed by a distribution phase. This scenario might benefit a younger beneficiary who wishes to postpone income until retirement.

**Match the CRT Term to the Income Beneficiary's Needs.** The trust term may be for a fixed period of time up to 20 years or, where the income beneficiaries are individuals, the term may continue for their lives so long as all are living at the time of funding. A trust for a fixed period of time is often selected for younger beneficiaries, when the donor wishes to benefit a class of beneficiaries (e.g., “my grandchildren”) all of whom may not be yet living, when the income stream is for a specific purpose (e.g., pay college expenses or underwrite a mortgage payment), or an entity is the income beneficiary. A third (less common) variation is to combine a life interest with a term interest.<sup>25</sup>

**Match the CRT Format to the Contemplated Contribution Asset.** The CRAT and SCRUT formats require sufficient liquidity to make immediate income beneficiary payments. Therefore, if the funding asset is an illiquid, unmarketable asset that produces insufficient cash flow to make the income beneficiary payments, then the NIMCRUT or Flip-CRUT format is preferable.

**Match the CRT Format to the Charity's Needs.** Because CRATs and SCRUTs must make their income beneficiary payments regardless of the amount of trust accounting income, there is a greater probability that the charity's interest will be reduced to make those payments. CRAT payout rates that exceed the actual investment return will not only result in a reduced remainder to the charity, but also create the potential that the trust will run out of money. CRUT payout rates that exceed the actual investment return will result in declining income payments to the income beneficiaries as well as a reduced remainder to the charity. Extended bear markets combined with a high payout rate also reduce the future value to charity. In the authors' experience, the highest donor and charity satisfaction seems to come from CRTs with payout ranges between 5 and 7 percent.

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<sup>24</sup> For this to occur, the spread between the payout rate and the net investment return must exceed the inflation rate.

<sup>25</sup> See Treas. Reg. §§ 1.664-2(a)(5) and 1.664-3(a)(5) for further discussion on combination terms.

Conversely, because NIMCRUT income beneficiary payments are limited to trust accounting income, there is a greater probability that the charity's interest will not be reduced even with a higher payout rate. The same can be said for a Flip-CRUT before the trigger occurs.

**Consider the Prohibition on Self-Dealing.** IRC § 4947(a)(2) prohibits CRTs from engaging in self-dealing transactions with disqualified persons. In general, a disqualified person includes the donor, the donor's family, the trustee, the trustee's family, any business entities or trusts in which these individuals have a greater than 35% interest and an individual with a greater than 20% interest in any business entity or trust which is a substantial contributor.<sup>26</sup> Further, self-dealing transactions include purchases, sales, leases, loans, excess compensation, and use of trust property.<sup>27</sup> Several exceptions apply.<sup>28</sup>

Some common examples of prohibited activities include:

- The donor continuing to reside in a home she has transferred to a CRT;
- The donor's child purchasing property from the CRT; and
- The trustee making a loan from the CRT to a business enterprise he owns and operates.

**Consider the Danger of Unrelated Business Taxable Income (UBTI).** In general, a CRT is exempt from Federal income taxation. However, for years in which a CRT has *unrelated business taxable income* (UBTI), the CRT will pay an excise tax of 100% on the UBTI received.<sup>29</sup> Certain types of assets produce UBTI and are, therefore, unsuitable for transfer to (or investment by) a CRT. Common examples of UBTI-producing assets or activities include:

- An interest in an active trade or business (regardless of whether it is classified as a sole proprietorship, a general partnership interest, a limited partnership interest, or a limited liability company (LLC) interest);
- A working interest in an oil and gas well; and
- Unrelated debt-financed income from trading on margin or other borrowing.

**Consider the Grantor Trust Rules.** While a CRT is generally exempt from the grantor trust rules,<sup>30</sup> the improper operation of a CRT can result in the application of one or more of the grantor trust rules. For example, using the income of the trust for the grantor's benefit – such as making the donor's mortgage payments – will convert the trust into a grantor trust which disqualifies the CRT. Other examples include using the CRT's income to pay life insurance premiums on a policy on the life of the donor or do-

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<sup>26</sup> IRC § 4946(a)(1).

<sup>27</sup> IRC § 4941(d)(1).

<sup>28</sup> See IRC § 4941(d)(2)(B)-(H).

<sup>29</sup> See IRC § 664(c)(2). Treas. Reg. § 1.664-1(c)(2) example 2 illustrates the use of the \$1,000 specific deduction described at IRC §512(b)(12) in computing a CRT's UBTI. § 664This effectively allows for a *de minimis* amount of UBTI from partnerships, unrelated debt-financed income, and income received from securities acquired on margin.

<sup>30</sup> See IRC § 664(a) and Treas. Reg. § 1.664-1(a)(4).

nor's spouse<sup>31</sup> and a donor's retention of a power to sprinkle income among trust beneficiaries.<sup>32</sup>

## Drafting the CRT Document

**Ensure the Document Drafted Supports the Plan Design.** It is important to remember that a CRT is irrevocable. Therefore, it is critical to draft the document correctly the first time. An example is when the donor wants a SCRUT and the document is drafted as a CRAT. Or, the donor desires the flexibility to request that the trustee make accelerated distributions of trust principal to the charitable remainder beneficiary and the provision is omitted. This is an even greater danger when the attorney engaged to draft the CRT governing instrument was not involved in the entire planning process.

**Beware of Using Generic Form Documents.** Numerous sample CRT documents are available from a variety of sources. For example, the IRS issued a series of sample CRT documents in 1989,<sup>33</sup> 1990<sup>34</sup>, 2003,<sup>35</sup> and 2005.<sup>36</sup> Most books of trust forms have one or more samples—many based on the IRS sample documents. Often continuing legal education seminars will include a copy of the presenter's standard form. Alternatively, it is common to borrow from colleagues that have previously drafted CRTs.

While it is tempting to use a document from one of the above sources and only change the names of the parties, the payout rate, and the term; the multitude of design variables (including trust format) makes this practice inadvisable. The authors have seen many CRTs that include conflicting provisions (such as a SCRUT agreement that referenced the make-up amount) because the drafter failed to identify all of the edits necessary to convert a sample trust to one that conforms to the plan design. Other examples of errors include trust documents that:

- Reference a different client and/or the wrong charitable remainder beneficiary;
- Incorrectly specify multiple payout rates;
- Fail to properly address the gift tax ramifications of naming someone other than the donor or the donor's spouse as an income beneficiary;
- Prohibit the trustee from accepting specific types of assets—including the asset actually contributed to the CRT;

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<sup>31</sup> IRC § 677(a)(3).

<sup>32</sup> IRC 674(a).

<sup>33</sup> See Revenue Procedures 89-20 (sample charitable remainder unitrust) and 89-21 (sample charitable remainder annuity trust). The revenue procedures were superseded by revenue procedures issued in 2003 and 2005.

<sup>34</sup> Revenue Procedures 90-30 and 90-31 (sample charitable remainder unitrust forms), and 90-32 (sample charitable remainder annuity trust forms). The revenue procedures were superseded by revenue procedures issued in 2003 and 2005.

<sup>35</sup> See Revenue Procedures 2003-53, 2003-54, 2003-55, 2003-56, 2003-57, 2003-58, 2003-59, and 2003-60 for sample charitable remainder annuity trust forms.

<sup>36</sup> See Revenue Procedures 2005-52, 2005-53, 2005-54, 2005-55, 2005-56, 2005-57, 2005-58, and 2005-59 for sample charitable remainder unitrust forms.

- Directly authorize acts of self-dealing;
- Omit the power to change the charitable remainder beneficiary when the donor desires this power;
- Include the power to change the charitable remainder beneficiary when the donor doesn't desire this power, for example to qualify for donor recognition or gift matching;
- Restrict the charitable remainder interest to public charities when the donor intends to create a private family foundation; and
- Permit the charitable remainder interest to be paid to a private foundation, thereby limiting the donor's income tax charitable deduction to basis.

**Adequately Define Principal and Income.** Many charitable plans call for the use of a NIMCRUT or Flip-CRUT. These CRT formats must pay out the lesser of the trust's accounting income and the unitrust amount (note that for Flip-CRUTs we are referring to the "pre-flip" period).

The definition of trust accounting income is a function of the language of the trust's governing instrument and the principal and income statute of the applicable state. Where one or more provisions of the trust's governing instrument are in conflict with the principal and income statute, the trust's governing instrument takes precedence.

It is sometimes the case that the trustee will select investment assets that do not produce income under the default provisions of the applicable principal and income statute. For example, realized capital gains are generally not considered income (but rather are treated as principal) under most state statutes. Therefore, it is desirable in the course of designing and drafting the trust's governing instrument to consider provisions that will match the anticipated investment practice with a definition of income that meets the plan design.

**Consider Desirable Optional Provisions.** A number of desirable optional provisions exist that can increase the utility and flexibility of a CRT. For example, the donor may retain the power to change the charitable remainder beneficiary. The donor may provide the trustee with the ability to accelerate the distribution of principal to the charitable remainder beneficiary. The trust might have a spendthrift clause designed to restrict the income beneficiary's ability to alienate his or her interest, while still giving the income beneficiary the flexibility to make a charitable gift of his or her income interest.

## Computing and Claiming the Income Tax Deduction

The deduction allowed for a transfer to a CRT is equal to the APVRI. The APVRI is computed by multiplying a remainder factor times the value of the asset transferred.<sup>37</sup> Many inputs impact the computation of the remainder factor. Among them are the expected term of the trust, the payout rate, the prescribed federal rate, and the frequency of the income payments.

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<sup>37</sup> In general, the present value factor is applied to the fair market value of the contributed asset. However, the present value factor is applied to the donor's basis for certain gifts. See IRC §§ 170(e)(1), 170(b)(1)(C)(iii).

The bottom line is that the longer the charity must wait and the greater the income payments to the income beneficiaries, the lower the amount of the charitable deduction. This computation is complex and is generally performed using specialized software. Some websites do offer limited versions of calculation software on either a pay, free or trial basis.

For income tax purposes, the Internal Revenue Code limits the amount of the charitable deduction that individuals and C-corporations<sup>38</sup> can claim in any year to a percentage of their adjusted gross income. The type of asset transferred and type of charity named as a remainder beneficiary determine the specific percentage limitations that apply. To the extent that percentage limitations apply, any unused charitable deduction is carried forward for up to five years. The percentage limitations do not apply for gift, estate, or GST tax purposes.

The type of asset transferred and type of charity named as a remainder beneficiary may also invoke a separate set of rules that may reduce the income tax deduction. For example, if a private foundation is permitted to receive a portion of the remainder interest, then the donor's income tax deduction is limited to smaller of the donor's basis in the asset or the asset's fair market value. The primary exception to this rule is for gifts of unrestricted publicly traded stock. For this reason, if the CRT will be funded with assets other than unrestricted publicly traded stock, the charitable remainder interest is usually limited to a public charity. A public charity alternative to a private foundation is a donor-advised fund.

Because of the percentage limitations and reduction rules described above, it is a best practice for a CRT's governing instrument to either affirmatively permit or affirmatively disallow a private foundation as a potential remainder beneficiary. To affirmatively disallow a private foundation, the instrument should specify that permissible remainder beneficiaries must be described by IRC § 170(b)(1)(A). This requirement is in addition to references to the relevant income (§ 170(c)), gift (§ 2522(a)) and estate (§ 2055(a)) tax provisions.

In order to claim an income tax charitable deduction, strict substantiation requirements must be met. For gifts of most unmarketable assets that result in claiming or reporting a deduction greater than \$5,000,<sup>39</sup> a qualified appraisal must be obtained.<sup>40</sup> Failure to obtain a qualified appraisal will generally result in the disallowance of the income tax charitable deduction and may result in the application of negligence and other penalties.

**Selecting the Appropriate AFR.** Among the various inputs used in computing the actuarial present value of a CRT's remainder interest (APVRI) is the applicable federal rate, or AFR, described at IRC § 7520. When an income, estate, or gift tax charitable contribution deduction is allowable as the result of a transfer of property, IRC § 7520(a) provides that a taxpayer may choose the AFR for the month of the gift or *the two previous months*.

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<sup>38</sup> Gifts by other entities are beyond the scope of this outline.

<sup>39</sup> For gifts of nonpublicly traded stock, the dollar threshold increases from \$5,000 to \$10,000. See Treas. Reg. § 1.170A-13(c)(2)(ii)(B)(1).

<sup>40</sup> See Treas. Reg. §§ 1.170A-13(c)(1)(i), 1.170A-13(c)(2) and (3).

This choice is important because selecting the highest available AFR for a CRT will increase the APVRI. Changes in the AFR have a significantly greater impact on the APVRI for CRATs than for CRUTs.

## Income Taxation of CRTs

**The Trust.** In general, a CRT is exempt from Federal income taxation. However, for years in which a CRT has *unrelated business taxable income* (UBTI), the CRT will pay an excise tax of 100% on the UBTI received.<sup>41</sup> Taxation by the states is unique to each state. Some states (such as Pennsylvania and New Jersey) do not exempt the CRT from taxation. Other states (such as Indiana) exempt CRTs from taxation, but require that a copy of the IRS Form 5227 be filed with the state taxing authority.

**Income Beneficiaries.** CRT distributions to income beneficiaries are taxed under a unique system commonly called "4-tier accounting." This system employs a "worst-in-first-out" method for characterizing income distributions in the hands of the income beneficiaries. Each item of income earned by the trust must be separately tracked according to type (e.g. interest, dividends, capital gains, tax-exempt interest, etc.). Then each type of income is "used up" starting with items taxed at the highest rate and moving to items that are taxed at the next lower rate.

The end result is that ordinary income items, such as interest and dividends, are passed out first, followed by short-term capital gains, then long-term capital gains, tax-exempt interest, and finally trust principal. Any CRT earnings in excess of the income beneficiary distributions are retained in the trust in a tax-free environment and combined with future transactions for characterizing future income beneficiary distributions. Note that while the CRT avoids taxation on capital gains realized from the sale of appreciated assets, such gains may be used to characterize future income beneficiary distributions.

## Operation and Administration

**Making Proper Payments.** Several potential traps exist regarding the proper amount to pay the income beneficiary. For example, like most other trusts, a CRT must use the calendar year as its tax year.<sup>42</sup> As a result, it will have a short tax year in the first and last year of the trust. It is sometimes forgotten that, for any short year, it is necessary to prorate the annuity or unitrust payment. The proration is done on a daily basis. The proration factor has as its numerator the number of days in the short year, inclusive of the first and last days of the year under consideration. The denominator is 365, or 366 if February 29 is included in the numerator.<sup>43</sup>

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<sup>41</sup> See IRC § 664(c)(2). It is the opinion of the authors that a CRT is permitted to claim the \$1,000 specific deduction described at IRC §512(b)(12) in computing its UBTI. The basis for this opinion is that IRC § 664(c)(2) refers to unrelated business *taxable* income. Unrelated business taxable income is income from a trade or business reduced by certain deductions including the \$1,000 specific deduction. This effectively allows for a *de minimis* amount of UBTI from partnerships, unrelated debt-financed income, and income received from securities acquired on margin.

<sup>42</sup> See IRC § 44.

<sup>43</sup> See Treas. Reg. § 1.664-2(a)(1)(iv)(a) and (b) and Treas. Reg. § 1.664-3(a)(1)(v)(a) and (b).

Examples of other traps include:

- Assuming that the current year's unitrust payment will be the same as the prior year's unitrust payment, and
- Paying the income beneficiary of a NIMCRUT or a Flip-CRUT (pre-flip) the full fixed percentage amount without regard to the trust's accounting income.

**Importance of Making Payments.** It is important that the trustee of a CRT actually make the payments to the income beneficiary. Similarly, it is important for the income beneficiary to demonstrate that he or she took possession of the payments (e.g., deposited the checks in a personal account). In *Estate of Melvine B. Atkinson v. Commissioner*,<sup>44</sup> the 11<sup>th</sup> Circuit Court of Appeals affirmed the Tax Court's ruling that the failure of the trustee to make the annuity payments of a CRAT caused it to fail to qualify for treatment as a CRT on operational grounds.

**Tracking the Make-up Amount.** Where a CRT is a NIMCRUT or a Flip-CRUT (pre-flip), then it is necessary to properly track the make-up amount. Note that additions to this amount occur each year that the trust accounting income is less than the unitrust amount. Deductions from this amount occur each year in which trust accounting income exceeds the unitrust amount. *Payments of the excess of trust accounting income over the unitrust amount are mandatory to the extent of the make-up amount.*

**Respecting the Payment Frequency.** One of the elements used to compute the APVRI is the frequency with which income beneficiary payments are to be made. While payments must be made each tax year, the trust's governing instrument may specify that payments are to occur more frequently than annually. Making payments more frequently than specified in the trust's governing instrument violates a key assumption used in computing the amount of the income tax charitable deduction and may call into question the validity of the deduction. In addition, failure to observe and respect the provisions of the trust's governing instrument may open the trustee to liability for breach of his or her fiduciary duty. It is therefore clearly advisable to not make payments on a greater frequency than that specified in the trust agreement.

**CRTs That Run Out of Money.** It is possible for a CRT (particularly a CRAT) to exhaust. When a CRT created for the benefit of a key donor exhausts, it is tempting for a charity serving as trustee to continue to make payments to the donor from its general fund—much in the same manner as a charitable gift annuity. However, this is a path to a bigger problem. Such payments constitute private inurement and may subject the charity to the Intermediate Sanctions of IRC § 4958.

**Tax Reporting by the Donor.** In general, the donor may be required to prepare two forms with respect to his or her transfer to a CRT. **Form 8283 Noncash Charitable Contributions** is attached to the donor's Form 1040 to report the income tax charitable deduction claimed by the donor for a gift of non-cash property to a CRT. Additionally, if the donor claims a charitable deduction for a non-cash gift that exceeds \$500,000, then

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<sup>44</sup> *Atkinson v. Commissioner*, 309 F.3d 1290; 90 A.F.T.R.2d 2002-6845; 2002-2 U.S.T.C. ¶ 60449 (11th Cir. 2002).

the donor must attach a copy of the qualified appraisal to the tax return claiming the deduction.

**Form 709** *United States Gift (and Generation-Skipping Transfer) Tax Return* is used to report the charitable gift for gift tax purposes. The same form is also used to report taxable gifts to the spouse and/or other income recipients. Note that since August 6, 1997, it is clear that IRC § 019 does not exempt charitable contributions to a CRT from the gift tax filing requirement. However, this is not without benefit because filing Form 709 starts the running of the statute of limitations on the valuation of the contributed asset for gift tax purposes (not for annuity or unitrust valuation purposes).

Funding of a testamentary CRT, however, requires filing **Form 706** *United States Estate (and Generation-Skipping Transfer) Tax Return* to claim the estate tax charitable deduction.

### **Tax Reporting by the CRT**

*Proper 4-Tier Classification.* The key to accurate tax reporting by the CRT is the proper classification of all trust activity according to the 4-tier classification scheme unique to CRTs.<sup>45</sup> The scheme requires the tracking of trust activity according to income type (i.e., non-qualified dividends, interest, royalties, rents, annuity income, qualified dividends) and tax rate (i.e., short-term capital gains, 28% rate gains, unrecaptured § 1250 gain subject to the 25% rate, 15% long-term capital gains, etc.). In effect, these refined classifications act as “sub-tiers” within the more broadly defined 4-tiers (ordinary income, capital gains, tax-free income, and corpus). As described above, income beneficiary payments result in relieving each sub-tier of the same tax rate within a tier on a pro-rata basis—beginning with the ordinary income tier until it is exhausted, continuing through the capital gain tier until it is exhausted, and so on.

*Filing the Proper Form.* Revenue Procedure 83-32 lists the filing requirements for CRTs. In general, a CRT only needs to annually file Form 5227 *Split-Interest Trust Information Return*. A copy of the trust instrument accompanied by a certification of its conformity to the original must be submitted with the initial Form 5227.

Other potential filing requirements include:

**Form 8283** *Noncash Charitable Contributions*. The CRT trustee should sign the donee acknowledgement section of Form 8283.

**Form 8282** *Donee Information Return*. If Form 8283 was prepared for the contribution to the CRT and the contributed asset is sold within 3 years, then the CRT trustee must file Form 8282 to report the sale price of the asset. The return must be filed within 125 days of the disposition of the contributed property. Note that this provides a way for the IRS to compare the value used to claim the deduction with the amount realized by the CRT.

**Form 4720** *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*. As previously noted, a CRT is subject to the private foundation rules regarding self-dealing. If a CRT has engaged in an act of self-dealing with a disqualified person, then

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<sup>45</sup> See IRC § 664(b) and Treas. Reg. § 1.664-1(d).

Form 4720 is used to disclose the act, describe the corrective action taken, and compute the excise taxes on the foundation manager (i.e., the trustee) and the disqualified person. A CRT also must file Form 4720 for each year in which it has UBTI.

*State Registration Requirements.* Some states (for example Illinois and Oregon) require that CRTs register as charitable trusts with the state Attorney General. This requirement complements the Federal information return requirements and any state income tax reporting requirements.

*Valuation.* Unmarketable assets provide the greatest challenge in valuing a trust's assets. A CRT trustee will need to know the value of the trust's assets in a number of situations. For example:

- Valuing the initial contribution to the trust;
- Determining the annual valuation of the trust's assets and liabilities required to compute the unitrust amount;
- Valuing additional contributions for the incremental change in the unitrust amount; and
- Computing how much of an asset to transfer to make an in-kind distribution.

Treas. Reg. § 1.664-1(a)(7) provides the trustee with two alternative methods for securing the value of a CRT's unmarketable assets. First, the valuation can be performed exclusively by an independent trustee. Second, the value can be determined by a current qualified appraisal.

*Compliance.* In order to ensure the continued qualification of a CRT, it is important for the trustee, the investment manager, the administrator, the attorney (and any other professional advisor) to be familiar with the laws and regulations governing CRTs and the terms of the governing instrument. All of the parties to a CRT must continually monitor the activity of the trust for compliance. Among the specific areas of concern are trustee powers, principal and income allocations, prohibited investments, self-dealing transactions, and transactions that could produce UBTI.

*Annual Reporting.* In some states, the trustee is required to make a periodic statement or accounting to the income beneficiaries, remainder beneficiaries, and/or a court. Charities that prepare financial statements in accordance with generally accepted accounting principles (GAAP) are required to include certain information about charitable remainder trusts. The type of information to be included depends on whether the charity serves as trustee (or not) and whether the charity's interest is revocable or irrevocable.

## Investments

**Prudent Investor Standard.** In selecting a CRT's investment portfolio, the trustee must be aware of the standard under which his or her decisions will be evaluated. Since its promulgation in 1994, many states have enacted a version of the Uniform Prudent Investor Act. This act permits a trustee to invest for total return based on Modern

Portfolio Theory. A trustee is therefore evaluated on the performance of a portfolio considered as a whole, rather than the performance of each individual asset.

Warning: “Total Return Unitrust” (TRU)<sup>46</sup> provisions alter the definition of trust accounting income. In regulations, the IRS has specifically ruled that a NIMCRUT may not make use of a TRU definition of income—even if permitted by state law.<sup>47</sup>

**Don’t Be a Slave to the Payout Rate.** It is not necessary, and may be undesirable, to match the investment return to the payout rate. For example, if a CRT uses a 12% payout rate, it would not be necessary to invest speculatively to achieve a 12% or greater investment return. Similarly, if the payout rate were 5%, it is not necessarily correct (or prudent) to only purchase a fixed income portfolio returning 5%. Rather, a CRT trustee should invest for total return while keeping in mind all of the relevant factors (e.g., the risk/reward profile, the trust format, liquidity requirements, etc.).

**Make Sure the Investment Philosophy (i.e., the Risk Profile) is that of the CRT—not Just the Income Beneficiary and not Just the Charity.** By definition, a CRT is a split-interest trust. As such, the trustee has a duty to impartially balance the interests of the income and remainder beneficiaries. This duty extends to the identification of a risk profile that blends the relative risk profiles of the income and remainder beneficiaries. In identifying the CRT’s risk profile, the trustee should consider such factors as the remaining term of the trust, the sophistication of the income and remainder beneficiaries, prevailing economic conditions, anticipated inflation, the required trust payout, the trust format and liquidity needs, tax efficiency as it relates to the expected income beneficiary distributions, and restrictions in the governing instrument. Because these factors may differ from CRT to CRT, it follows that not all CRTs should be invested in the same way.

**Make Sure the Person Picking the Investments Knows the Rules.** The person selecting a CRT’s investment portfolio must be aware of certain rules peculiar to CRTs. For example, the trustee should avoid: purchasing assets that produce UBTI; purchasing securities on margin or otherwise borrowing funds to avoid unrelated debt-financed income (a form of UBTI); and entering into transactions that are subject to the IRC § 4941 excise taxes on self-dealing. If there is a charitable income interest, then the trust must avoid excess business holdings (IRC § 4943) and jeopardizing investments (IRC § 4944).<sup>48</sup>

Because a CRT’s distributions to the income beneficiaries are taxed under the quasi-passthrough “4-tier” system,<sup>49</sup> it is important for the trustee to understand how the investment portfolio selected interacts with the 4 tiers. For example, the tiers segregate earnings by income class and the tax rate imposed on the beneficiary. If the investments selected produce income that populates lower tax rate tiers, then it is possible for

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<sup>46</sup> As applied to non-CRT trusts, the “Total Return Unitrust” concept creates an environment that permits trustees of those trusts to invest for total return without the necessity for computing an income beneficiary’s payment on traditional definitions of trust accounting income.

<sup>47</sup> See Treas. Reg. § 1.664-3(a)(1)(i)(b)(3).

<sup>48</sup> However, the trust must be subject to §§ 4943 and 4944 beginning at the end of the CRT term if by it’s the trust continues as a private foundation.

<sup>49</sup> See IRC § 664(b) and Treas. Reg. § 1.664-1(d).

income beneficiary distributions to be taxed at a lower rate. However, the carryover nature of the tiers means that carryovers within a higher tax rate tier will override current year income that is otherwise taxed at a lower rate. The classic example of this phenomenon is that a large capital gain carryover (typically from the sale of a contributed asset in a prior year) overrides the current production of tax-free municipal bond interest in determining the tax character of income beneficiary distributions.

## Gift, Estate, and GST Tax Considerations

**General Comments.** A charitable remainder trust should not pay the estate tax or gift tax of the donor. In addition to creating potential self-dealing issues, this is expressly prohibited by Revenue Ruling 82-128. The best practice is for all CRT governing instruments to echo this express prohibition.

**Gift Tax.** The creation of an income interest for a person other than the donor creates a gift equal to the value of the property transferred less the APVRI. If the donor's spouse is the only person other than the donor to receive an income interest, then the gift tax marital deduction (IRC § 2523(g)) eliminates most gift tax concerns. If the CRT is properly designed, no tax will be due for the gift of the charitable interest.

If the donor or the donor's spouse is not a recipient of any income interest (e.g., the donor's children are the named recipients), then the donor has made a taxable gift to the income beneficiary. This gift may qualify for the annual gift tax exclusion<sup>50</sup> to the extent it is an immediate interest valued at \$13,000 or less. To the extent that the gift is greater than \$13,000, then the donor's lifetime gift tax applicable exclusion amount will be reduced or gift tax will be due.<sup>51</sup>

A third variation is to create an income interest for the donor succeeded by his or her spouse succeeded by one or more children. While this can be a powerful planning technique, it does produce a challenging gift tax result. The inclusion of a non-spousal recipient nullifies any gift tax marital deduction for the spouse's interest.<sup>52</sup> This means that both the children and the spouse's interests are presently subject to gift tax. By retaining a testamentary right to revoke all income interests (but his or her own), a donor can eliminate the gift tax. However at the donor's death, the donor will only receive an estate tax charitable deduction for the remainder interest—there will not be a marital deduction for the spousal interest.

**Estate Tax.** It is common for the assets of a CRT to be included in the donor's gross estate. This can occur for a variety of reasons including:

*Retaining an Income Interest.* IRC § 2036 requires estate inclusion of trust assets created by the donor if the donor retained a lifetime income interest.

*Retaining a Right to Revoke a Surviving Income Recipient.* IRC §§ 2036 and 2038 require estate inclusion of trust assets for trusts created by the donor if the

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<sup>50</sup> The gift tax annual exclusion under IRC § 2503(b)(1) is indexed for inflation under IRC § 2503(b)(2). The 2011 gift tax annual exclusion amount is \$13,000..

<sup>51</sup> Retention of a testamentary right to revoke an income interest complicates determining the gift tax.

<sup>52</sup> IRC § 2523(g).

donor retained a power to designate a beneficiary. The power to revoke a surviving income recipient fits this category.

*Retaining a Right to Change the Charitable Beneficiary.* IRC §§ 2036 and 2038 require estate inclusion of trust assets for trusts created by the donor if the donor retained a power to designate a beneficiary. The power to change the charitable beneficiary fits this category.

As a reminder, any one of these items—by itself—is sufficient to cause the assets to be included in the donor’s gross estate. However, this does not mean that there is a tax due for single-life or spousal CRTs. Between the estate tax charitable deduction and (for spousal CRTs) the estate tax marital deduction, the value of the CRT assets included in the donor’s estate is effectively eliminated.<sup>53</sup> However, the fact that the gross estate net of the available deductions is less than the estate tax applicable exclusion amount does not eliminate the requirement to file Form 706.

As with all estate tax computations, if the gross estate (including the CRT assets and other lifetime gifts) is valued at less than the estate tax applicable exclusion amount, the inclusion of the CRT assets will not create an estate tax liability. For estates whose value exceeds the estate tax applicable exclusion amount, a testamentary CRT may be a strategy for reducing the value of the estate below the limit, while providing a benefit to the donor’s spouse, heirs, and charity.

Table 1 below lists the estate, gift, and generation skipping transfer tax rates and applicable exclusion amounts. The Gift, Estate, and GST tax rates and Exclusion Amounts after 2012 are subject to uncertainty. The table reflects what will happen if Congress takes no action.<sup>54</sup>

<b>Year</b>	<b>Highest Estate and GST Tax Rates</b>	<b>Estate Tax Applicable Exclusion Amount</b>	<b>GST Exemption Amount</b>	<b>Highest Gift Tax Rate</b>	<b>Gift Tax Applicable Exclusion Amount</b>
2011	35%	\$5,000,000	\$5,000,000	35%	\$5,000,000
2012 <sup>55</sup>	35%	\$5,120,000	\$5,120,000	35%	\$5,120,000
2013+	55%	\$1,000,000	\$1,000,000*	55%	\$1,000,000

\*Actual number determined by index.

**Generation-Skipping Transfer Tax (GSTT).** The enactment of the 10% remainder test in 1997 significantly reduced the danger that a CRT will create generation skipping transfer tax (GSTT) concerns. Nevertheless, any CRT that names a skip person<sup>56</sup>

<sup>53</sup> For a limited number of estates, inclusion of the value of the CRT’s assets in the donor’s gross estate may limit the estate’s eligibility to claim a special use valuation, IRC § 166 deferral of tax, or IRC §303 redemption.

<sup>54</sup> If Congress does extend the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which was signed on December 17, 2010, then the Gift, Estate, and GST Applicable Exclusion Amounts will continue to be indexed for inflation for years after 2012. However, Table 1 reflects what will happen if Congress takes no action.

<sup>55</sup> Rev. Proc. 2011-52, § 3.29.

<sup>56</sup> See IRC § 2613 for the definition of a skip person.

as an income beneficiary must address the GSTT. Some examples of CRTs that have a higher probability of GSTT complications include term of years CRTs, CRTs that combine lives and terms, CRTs that benefit non-direct descendants (e.g. nieces, nephews, non-spousal May-December relationships) where the donor is more than 37½ years older than the CRT beneficiary. Note that GSTT concerns exist *whenever* a skip person is named, *even if* there is an intervening non-skip beneficiary.

**Allocation of GST Exemption.** Even though a transfer to a CRT may be a generation-skipping transfer, it is possible for the donor to allocate all or a portion of his or her GST exemption to the transfer.

## Post-Mortem Planning with CRTs

The actuarial present value of a CRT's remainder interest must be at least 10% of the value of the contributed assets. The combined life expectancies of all measuring lives are a key factor in computing the remainder interest. Unfortunately, when designing a donor's estate plan it is impossible to know what the combined life expectancies of the donor's children will be at the donor's death. Therefore, it is advisable to determine the degree of discretion the donor is willing to grant the executor in altering the CRT terms to pass the 10% test.

For example, some donors find comfort in knowing that a 20-year term-certain CRUT with a payout rate of 10% or less will always pass the 10% test. Alternatively, because fewer measuring lives increases the probability that a trust will pass the 10% test, the donor can grant the executor discretion to create separate CRTs for the life of each child.

Three primary options are available for CRTs that fail the 10% test. All three options are available both when the CRT is initially funded as well as for each additional contribution to a CRUT. First, the CRT (or the additional contribution) can be declared null and void *ab initio*.<sup>57</sup> A second, more common solution is to reduce the CRT's payout rate until the 10% test is met.<sup>58</sup> The third solution is to reduce the payout period.<sup>59</sup> The third solution could include removing one or more noncharitable income beneficiaries, changing the payout term from lives to a term of years or reducing the term of years.

## Disclaimer Planning with CRTs.

Opportunities exist for donors to use disclaimer planning to create alternative scenarios in their estate plan. For example, a donor's will could provide that \$4 million be transferred outright to her spouse, however if her spouse disclaims his interest,<sup>60</sup> then the \$4 million would be transferred to a CRT for the benefit of their children and a named charity.

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<sup>57</sup> See IRC § 2055(e)(3)(J)(i). See also PLR 201040021 in which the CRT was declared null and void multiple years after the purported CRT was initially funded.

<sup>58</sup> See IRC § 2055(e)(3)(J)(ii).

<sup>59</sup> See IRC § 2055(e)(3)(J)(ii).

<sup>60</sup> See IRC § 2518.

## Benefits to Donors

The charitable remainder trust has become a familiar tool in the gift planner's toolbox. CRTs are flexible enough to solve a myriad of donor charitable, financial, and non-financial problems. A best practice is to use a CRT to accomplish multiple donor goals. For example, CRTs can:

- Increase cash flow
- Avoid capital gain taxes
- Reduce income, gift, and/or estate taxes
- Plan the donor's estate
- Transfer money to heirs
- Maximize charitable giving
- Diversify concentrated stock or other illiquid assets
- Preserve wealth for the family

Much of the power behind the CRT is based on its tax-exempt status and irrevocable nature. CRTs can be funded with a variety of assets including stocks, bonds, mutual funds, restricted securities, exchange traded funds, real estate in various forms, partnership interests, limited liability companies (LLCs), S-corporations,<sup>61</sup> C-corporations, and art and other tangible personal property. When combined with a WRT, the CRT can solve many of your donor's noncharitable problems within a charitable context.

All donors like to be thanked and many like to be recognized. A CRT can enable donors to realize charitable goals that seem beyond their reach. For example, making a current gift to endow a chair in the donors' name at their *alma mater* may not be feasible, but by utilizing a CRT, this goal can be brought within the donors' grasp.

Often the CRT concept can be used again and again to address a donor's charitable, financial, and non-financial goals.

## Benefits to Charities

CRTs are a bread-and-butter part of any full-service planned giving program. The most obvious benefit is the charitable remainder. Other benefits include enhanced donor relations (with the prospect of other current gifts), possible income beneficiary opportunities, testimonials, creating opportunities to engage donors with new and exciting programs, etc.

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<sup>61</sup> Note that while S-corporation stock can be transferred to a CRT without disqualifying the CRT, doing so will immediately terminate the corporation's S-election. Therefore, this type of transfer should only be done where all other shareholders and any prospective purchaser of the corporation do not require that the S-election remain intact.

## Appendix A

### IRS Charitable Remainder Trust Statistics

Each year the Statistics of Income division of the IRS publishes tables and a paper based on a statistical study of IRS Forms 5227, which were filed for a tax year.<sup>62</sup> The tables below present a compilation of selected statistics from the last eight tax years of data published by the IRS.

The data indicates that the 80/20 rule applies to the breakdown of CRUTs vs. CRATs, with CRUTs comprising 83.78% of all CRTs. However, when reviewing the “Book Value” of all CRTs, CRUTs comprise 92.19% of the Book Value of CRT Assets. Note that the CRUT values include both Book Values and Market Values while the CRAT values include only Book Values because each type of trust reports slightly different numbers to the IRS.

During tax year 2008, most CRUTs (86.4%) had a unitrust amount between 5% and 10%. Further, 77.9% of CRUTs were SCRUTs, another 17.3% were NIMCRUTs and the remaining 4.8% were NICRUTs.

Donors contributed to 4.6% of all CRTs during 2008. This included newly-created CRTs as well as additional contributions to previously existing CRUTs. Donors created approximately 2,630 new CRTs during 2008, while roughly 2,950 CRTs made their terminating distribution to charity.

#### IRS CRT Statistics (for Tax Years 2005 through 2008)<sup>63</sup>

*Money amounts are in thousands of dollars*

	2008	2007	2006	2005
<b>Number of CRUTs (all types)</b>	95,928	96,248	95,567	94,767
Market Value of CRUTs	\$92,165,720	\$119,198,640	\$106,425,220	\$96,835,553
Book Value of CRUTs	\$96,060,677	\$98,042,480	\$86,741,306	\$81,121,949
Percentage of Total Number	83.78%	83.34%	82.56%	81.65%

<sup>62</sup> Because the study covers IRS Form 5227, the study also addresses some data about Charitable Lead Trust and Pooled Income Funds.

<sup>63</sup> Sources: Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2003, “Split-Interest Trusts, 2000,” Washington D.C. [www.irs.gov/pub/irs-soi/00spintr.pdf](http://www.irs.gov/pub/irs-soi/00spintr.pdf); Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2003-2004, “Split-Interest Trusts, 2001,” Washington D.C. [www.irs.gov/pub/irs-soi/01trust.pdf](http://www.irs.gov/pub/irs-soi/01trust.pdf); Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2004-2005, “Split-Interest Trusts, 2002,” Washington D.C. [www.irs.gov/pub/irs-soi/02eorust.pdf](http://www.irs.gov/pub/irs-soi/02eorust.pdf); Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2006, “Split-Interest Trusts, Filing Year 2004,” Washington D.C. [www.irs.gov/pub/irs-soi/04spintr.pdf](http://www.irs.gov/pub/irs-soi/04spintr.pdf); Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2006-2007, “Split-Interest Trusts, Filing Year 2005,” Washington D.C. [www.irs.gov/pub/irs-soi/05spintr.pdf](http://www.irs.gov/pub/irs-soi/05spintr.pdf); and Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2008, “Split-Interest Trusts, Filing Year 2006,” Washington D.C. [www.irs.gov/pub/irs-soi/06sptrust.pdf](http://www.irs.gov/pub/irs-soi/06sptrust.pdf); Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2009, “Split-Interest Trusts, Filing Year 2007,” Washington D.C. [www.irs.gov/pub/irs-soi/09winbultrusts.pdf](http://www.irs.gov/pub/irs-soi/09winbultrusts.pdf); and Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2010, “Changing Times: An Analysis of the 2007 Revision of the Split-Interest Trust Information Return,” Washington D.C. [www.irs.gov/pub/irs-soi/10winbulchangingtimes.pdf](http://www.irs.gov/pub/irs-soi/10winbulchangingtimes.pdf).

**IRS CRT Statistics** (for Tax Years 2005 through 2008)<sup>63</sup>*Money amounts are in thousands of dollars*

	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>Number of CRATs</b>	18,572	19,241	20,187	21,296
Book Value of CRATs	\$8,139,773	\$8,931,574	\$9,080,252	\$9,041,175
Percentage of Total Number	16.22%	16.66%	17.44%	18.35%
<b>TOTAL NUMBER OF CRTs</b>	114,500	115,489	115,754	116,063
Total Book Value of CRTs	\$104,200,450	\$106,974,054	\$95,821,558	\$90,163,124

**IRS CRT Statistics** (for Tax Years 2001 through 2004)*Money amounts are in thousands of dollars*

	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
<b>Number of CRUTs (all types)</b>	94,779	93,329	91,371	89,874
Market Value of CRUTs	\$95,053,618	\$89,573,997	\$84,697,749	\$100,268,578
Book Value of CRUTs	\$79,845,710	\$77,368,620	\$81,564,412	\$84,282,040
Percentage of Total Number	81.39%	80.49%	80.04%	79.65%
<b>Number of CRATs</b>	21,667	22,626	22,783	22,958
Book Value of CRATs	\$9,540,935	\$9,464,536	\$9,596,835	\$10,177,555
Percentage of Total Number	18.61%	19.51%	19.96%	20.35%
<b>TOTAL NUMBER OF CRTs</b>	116,446	115,955	114,154	112,832
Total Book Value of CRTs	\$89,386,645	\$86,833,156	\$91,161,247	\$94,459,595