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To: Clients **From:** Stuart H. Sorkin, Esq.

Re: Charitable Remainder Trusts **Date:** 9/30/2020

In the simplest of terms, a person who establishes a Charitable Remainder Trust ("CRT") contributes property to a trust, the trust pays the income from the trust for either a fixed number of years (no more than 20 years) or the life of one or more individuals, typically for the lives of a husband and wife. At the end of the period, the charities designated in the trust receive the trust corpus. The person who creates the CRT will receive an income tax deduction for the present value of the remainder interest that will ultimately pass to the qualified charity. Government regulations determine this amount, which is essentially calculated by subtracting the present value of the annuity from the fair market value of the property and/or cash placed in the trust. The balance is the amount that the grantor can deduct when the grantor contributes the property to the trust.

There are two types of CRTs an annuity trust or a unitrust. In summary, an annuity trust effectively provides a fixed annuity to its income beneficiaries, while the unitrust provides a variable annuity. Under both types of CRTs, income payments must be made at least annually and principal of the trust cannot be used unless it is to satisfy a specific payout of income. The rate of return for both types of trust must be at least 5%. The following is a more detailed description of each type of CRT.

Charitable Remainder Unitrust

When a charitable remainder unitrust is established, a donor transfers cash and/or property to an irrevocable trust but retains (either for himself or for one or more non-charitable beneficiaries) a variable annuity (payments that can vary in amount, but are a fixed percentage) from that trust. At the end of a specified term, or upon the death of the beneficiary (or beneficiaries, and the donor and the donor's spouse can be the beneficiaries), the remainder interest in the property passes to the charity the donor has specified.

For calculations involving a term, the length of the economic schedule is limited to that term. Otherwise, the economic schedule illustrates the trust for life expectancy. If the number of lives is greater than one, then the length of the economic schedule will be determined by the joint life expectancy of the first two ages provided by the user. Single life cases will use the single life expectancy. The economic schedule will end if the trust is depleted of funds prior to the end of the schedule.

The principal difference between a charitable remainder unitrust and a charitable remainder annuity trust is that a unitrust pays a varying annuity. In other words, the amount paid is likely to change each year. The payable amount is based on annual fluctuations in the value of the trust's property. As it goes up, so does the amount of the annual annuity payment can rise each year. If it drops in value, so will the annuity.

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A gift to a charitable remainder unitrust will qualify for income and gift tax charitable deductions (or an estate tax charitable deduction) only if the following conditions are met:

- A fixed percentage (not less than 5% nor more than 50%) of the net fair market value of the assets is paid to one or more non-charitable beneficiaries who are living when the unitrust is established. The charity's actuarial interest must be at least 10% of any assets transferred to the trust. (See 26 U.S.C. §664(d)(2)(A).)
- The unitrust assets must be revalued each year, and the fixed percentage amount must be paid at least once a year for the term of the trust, which must be a fixed period of 20 years or less, or must be until the death of the noncharitable beneficiaries, all of whom must be living at the beginning of the trust.
- No sum can be paid except the fixed percentage during the term of the trust and at the end of the term of the trust, the entire balance of the trust's assets must be paid to one or more qualified charities.

The donor receives an immediate income tax deduction for the present value of the remainder interest that will pass to the charity at the end of the term.

Because a charitable remainder unitrust is exempt from federal income tax (the income and gains of the trust are only taxed when they are distributed to the noncharitable beneficiaries as part of the fixed percentage of trust assets distributed each year), they are frequently used to defer income tax on gains about to be realized. For example, if a donor has an appreciated asset that is about to be sold, the donor can give the asset to a charitable remainder unitrust, reserving the right to receive a fixed percentage of the value of the trust for life, and for the life of the donor's spouse as well, and the asset can then be sold by the trust and the proceeds of sale reinvested without payment of any federal income tax on capital gains. The capital gains will be taxable to the donor (or the donor's spouse) only as they are distributed to the donor as part of the annual distributions from the trust.

A variation of the CRUT (which pays a fixed percentage of the value of the trust assets, regardless of income) is the net-income CRUT, or "NICRUT," which pays either the fixed percentage or the income actually received by the trust, whichever is less. A variation of the 'NICRUT' is the net-income-with-makeup CRUT, or "NIMCRUT." This can be used if the income is less than the fixed percentage, which creates a deficiency that can be paid in a future year, as soon as the trust has income, which exceeds the fixed percentage. An additional variation is a "flip" unitrust, which is a trust that changes from a NIMCRUT to a regular CRUT upon the occurrence of a specific event, such as the sale of a specific asset that was contributed to the trust and was not expected to produce much income. However, NICRUTs, NIMCRUTs and "flip" CRUTs are valued in the same way as a regular CRUT for the purpose of determining the income, estate, and gift tax charitable deduction.

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Charitable Remainder Annuity Trust

When a charitable remainder annuity trust is established, a gift of cash or property is made to an irrevocable trust, and the donor (and/or another non-charitable beneficiary) retains an annuity interest in the property for a specified number of years or for the life or lives of the non-charitable beneficiaries. At the end of the term, the qualified charity specified in the trust document receives the property in the trust.

For calculations involving a term, the length of the economic schedule is limited to that term. Otherwise, the economic schedule illustrates the trust for life expectancy. If the number of lives is greater than one, then the length of the economic schedule will be determined by the joint life expectancy of the first two ages provided by the user. Single life cases will use the single life expectancy. The economic schedule will end if the trust is depleted of funds prior to the end of the schedule.

Most gifts made to a charitable remainder annuity trust qualify for income and gift tax charitable deductions (or in some cases an estate tax charitable deduction). A charitable deduction is permitted for the remainder interest gift only if the trust meets certain criteria.

A trust qualifies as a charitable remainder annuity trust if the following conditions are met:

- The trust pays a specified sum to at least one non-charitable beneficiary who is living when the trust is created. Sums are paid annually, semiannually, quarterly, monthly, or weekly.
- The sum paid annually must also be at least 5%, but less than 50% of the initial net fair market value of the property placed in the trust. The charity's interest at inception also must be worth at least 10% of the value transferred to the trust. (See 26 U.S.C. 664(d)(1)(A).)
- The sum is payable each year for a specified number of years (no more than 20) or for the life or lives of the noncharitable beneficiaries.
- No sum is paid to anyone other than the specified non-charitable beneficiary and a qualified charitable organization.
- When the specified term ends, the remainder interest is transferred to a qualified charity or is retained by the trust for the use of the qualified charity.
- The Internal Revenue Service has also ruled that a trust is not a charitable remainder annuity trust if there is a greater than 5% chance that the trust fund will be exhausted before the trust ends.

The annuity paid must be a specified amount expressed in terms of a dollar amount (e.g., each non-charitable beneficiary receives $500 a month) or in terms of a fraction or percentage of the initial fair market value of the property contributed to the trust (e.g., beneficiary receives 5% each year for the rest of his life).

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The grantor will receive an income tax deduction which is permitted immediately for the present value of the remainder interest that will ultimately transfer to the qualified charity. Government regulations determine this amount which is essentially calculated by subtracting the present value of the annuity from the fair market value of the property and/or cash placed in the trust. The balance is the amount that the grantor can deduct when the grantor contributes the property to the trust.

As a planning point, the best assets to contribute to a CRT are assets that have a low basis and do not generate substantial income. The reason for using these types of assets is the CRT can sell the assets at no taxable gain and purchase assets, which generate higher income to the non-charitable beneficiary.

An example is a person close to retirement who over the years has accumulated a substantial stock portfolio and he has a low cost basis in the stock portfolio. These stocks have a low dividend yield and he would like to increase his current income from his investments since he is close to retirement. However, if he sells the stock he will generate a substantial capital gain tax, which will reduce the amount of cash he may reinvest in the higher yielding investments. If he establishes a CRT and contributes the stock to the CRT, the CRT can sell the stock and pay no income taxes. The trust then purchases investments that yield a higher current rate of return. The CRT pays the income to the person who establishes the CRT and this same person also receives a tax deduction for his charitable contribution.

I hope you will find this memorandum useful and if you have any questions, please call me.

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