Charitable Remainder Trusts: Planning Considerations

Individuals who have included, or plan to include, bequests to The First Church of Christ, Scientist in their wills or living trusts often are better advised to accelerate their bequests through a charitable remainder trust (CRT) that provides a gift at death, but additionally offers income tax deductions, capital gains tax benefits, the assistance of a skilled trustee, the satisfaction (and recognition) of making a lifetime gift, plus a variety of other potential benefits. Establishing lifetime CRTs can, in many cases, be a solution to personal and family challenges. Indeed, donors may find that they truly can enjoy better living through charitable giving through creative application of charitable remainder unitrusts or annuity trusts. In recent years, CRTs have been employed to supplement retirement savings, educate grandchildren, pay alimony, liquidate art collections, sell businesses and support disabled family members – all in the context of invaluable assistance to the Church and tax-saving charitable deductions.

A Case Study in the Benefits of Charitable Remainder Trusts

Consider the case of Judith retired and living alone. Her two children, Robert and Caroline, are professionals earning good incomes. They and their children were well provided for through a trust set up under the will of Judith's husband, Al. Judith's sister, Amy, needs support. Judith would like to do that which would not only bless the Church, but would also provide additional support for Amy. Judith owns various properties, including some highly appreciated, low-yield stock worth about $190,000 and some highly appreciated, undeveloped real estate worth about $120,000. She has contemplated leaving these assets to the Church through her will. A number of personal and financial goals might be inferred from the foregoing description, many of which Judith might achieve through a charitable remainder unitrust.

- Judith can fund a charitable remainder unitrust with the stocks and real estate and retain lifetime payments of generally 5%, which can be paid to someone in a low tax bracket, such as her sister Amy, and then to a survivor beneficiary (Judith herself, for example), if desired.

- The Christian Science Trustees for Gifts and Endowments invest planned gift assets in a tax-sensitive manner, so that whenever possible trust payments are taxed at low dividend or capital gains tax rates. Judith's sister might pay minimal tax on her trust income if she is in a 15% tax bracket. Payments consisting of trust principal or tax-exempt interest may be free of taxation, irrespective of the beneficiary's tax bracket.

- No erosion from capital gains taxes or net investment income taxes occurs when the trustee liquidates Judith's stocks and real estate, which leaves the full $310,000 available for reinvestment.

- Judith can deduct roughly $150,000 (2.0% midterm rate) on her next tax return if the trust is to pay Amy 5% for life. Gift taxes can be minimized, with proper planning.

As the case study illustrates, charitable remainder trusts have the ability to:

- Increase a donor's income, or that of a loved one, by reinvesting low-yield or no-yield properties for a fixed or variable income, with a rate of return of generally 5%;

- Provide favorably taxed income if careful attention is given to how the trust is funded and invested;

- Avoid capital gains taxes when the trust is funded and when the trust assets are sold and reinvested by the trustee;

- Supply income tax and transfer tax charitable deductions, generally 20% to 50% of the amount transferred, depending on beneficiaries' ages or the length of the trust term;

Fundamentals of Charitable Remainder Trusts

Charitable remainder trusts are irrevocable trusts that donors establish for the benefit of designated income beneficiaries and one or more qualified organizations. The trusts can last for the lifetimes of the income beneficiaries or for a term of years (20-year maximum) or sometimes a combination of lifetimes and a term of years. Income tax and estate tax charitable deductions (10% minimum) reduce the cost of benefiting the Church and improve the donor's tax situation. Deductions depend on the ages and number of the income beneficiaries (or the term of years the trust is to last), the amount of income retained for the beneficiaries and the applicable federal interest rates in effect at the time the trust is established.

Charitable remainder trusts come in two varieties: annuity trusts and unitrusts. According to IRS statistics for 2010, 110,768 CRTs filed trust tax returns, of which 85% were unitrusts and 15% were annuity trusts, and the trend in recent years has been for donors to establish unitrusts. CRTs are commonly set up in amounts from $150,000 to $1 million, although $10 million trusts and larger have been established.

Annuity trusts pay an unchanging dollar amount to beneficiaries. The payout is unaffected by fluctuations in trust income or changes in the value of trust assets. Annuity trusts, except for term-of-years trusts, must pass a 5% probability test – that is, the trust will not qualify if there is more than one chance in 20 that the trust assets will be exhausted when the trust ends. Donors may not make additional contributions to annuity trusts. Annuity trusts are less common than unitrusts, in part because they are at risk in times of inflation, but primarily because they lack the flexibility and planning options of unitrusts. Falling interest rates also heighten the chances that annuity trusts will fail the 5% probability test or the 10% minimum charitable deduction requirement.

Unitrusts, so called because trust principal and trust income generally are treated as a unit in calculating payouts, pay beneficiaries a percentage of the value of the trust as revalued at least once a year. Payments will rise or decline according to the investment results experienced by the trustee. This arrangement is commonly called the "standard" unitrust. Additional contributions may be made to unitrusts, if the trust instrument so provides.

Payouts can be limited to the lesser of the trust's net income or the unitrust percentage – a net income or income exception unitrust – and provision also can be made for make-up or catch-up of deficiencies from years in which payouts were less than the payout percentage stated in the unitrust agreement. The trustee may make up prior years' deficiencies in payouts to the extent current income of the trust exceeds the specified unitrust amount. Note: The IRS has approved several trusts that defined realized capital gains as income for purposes of making payments and makeups from net income unitrusts (post-contribution gains only).

Flip unitrusts are the most recent variation in CRT design. Donors who fund trusts with real estate, closely held stock and other nonliquid assets historically have used a net-income or net-income with make up unitrust, which permitted the trustee to avoid or postpone income payments prior to the sale of the trust assets. Once property is sold, however, most donors prefer the fixed percentage payments offered by a standard unitrust. Unitrusts may contain provisions allowing them to flip from a net-income trust to a standard unitrust upon the occurrence of a specific date or triggering event, which must be outside the control of the trustees or any other persons. Examples of permissible triggering events include a beneficiary achieving a particular age, marriage, new child, or sale of unmarketable assets, such as real estate. Originally, the flip unitrust merely seemed to be a fix-up measure that would address the problem of donors who funded net-income unitrusts with vacant lots and later were left with low payouts. On closer examination, new or refined gift plans began to emerge. Examples (detailed later in this article) include situations where:

- The donor wants to make a gift today, obtain a tax deduction and receive lifetime income – but postpone most or all of the income until some future date (the year he or she retires, for example);
- The donor wants to help the Church and at the same time arrange for young grandchildren (or children) to receive payments when they start college – five, ten or 15 years in the future.

Taxation of CRTs and Beneficiaries

CRTs are tax exempt; however, any unrelated business taxable income (UBTI) will be taxed at a 100% tax rate (that is, UBTI will be confiscated). Rents and dividends from corporations generally are not considered unrelated business taxable income. UBTI also includes debt-financed income, which may occur if the trustee borrows funds to produce investment income or incurs debt to fix up real estate in the trust prior to selling. A portion of the eventual sale proceeds could be taxed at a 100% rate.

While CRTs are tax exempt, income beneficiaries are taxable on their payments, depending on the type of income earned by the trust. Under this four-tier system: (1) the trust's current and accumulated ordinary income (usually taxed at the beneficiary's highest rates) is considered first, then (2) current and accumulated capital gains (generally taxed at lower rates than ordinary income), (3) other (tax-exempt) income, and (4) corpus (also tax free). This is sometimes called the worst-in-first-out system, or WIFO. Except for trust income that was earned and accumulated before 2013, payments may also be subject to net investment income tax.

- **Tier One.** The annuity or unitrust payment is considered first to consist of ordinary income, to the extent the trust has any current or accumulated ordinary income, including interest, rents, royalties and dividends. Qualified dividends, which currently receive favored tax treatment, are considered to be distributed last.

- **Tier Two.** If the annuity or unitrust amount exceeds the current and accumulated ordinary income of the trust, it is deemed to consist of capital gain, to the extent the trust has any net capital gain for the current year or carried over from a prior year. Note that short-term gain is distributed before long-term gain. After short-term gain comes long-term gain taxed at a maximum of 28% (from the sale of collectibles), then 25% gain (from real estate as to which the donor claimed depreciation deductions), and finally gain taxed at a maximum rate of 15% or 20% (for taxpayers in the 39.6% bracket).

- **Tier Three.** The third tier consists of tax-exempt income – for example, municipal bond interest.

- **Tier Four.** The fourth tier consists of trust corpus. The trustee takes the donor's adjusted basis in gift assets, and any distribution of that basis, or cash, is always tax free.

Recent tax rate changes have increased the appeal of charitable remainder trusts. Lower capital gains rates are helpful to recipients of capital gain income from charitable remainder trusts. Trustees can sell capital gain property and reinvest in dividend stocks, and beneficiaries would enjoy income taxed either at low capital gains rates or low dividend tax rates

(15% or 20%). Capital gains tax avoidance remains a good incentive, especially for funding trusts with collectibles (28% capital gains tax rate) and commercial real estate on which donors have taken depreciation deductions (25% capital gains tax rate) and for persons in the 20% capital gains tax bracket – who also face 3.8% net investment income tax. Commercial properties, such as apartments and office buildings, should be good candidates, so long as they are debt free.

What Are the Payout Options and Alternatives?

Charitable remainder trusts generally make payments for the lifetimes of one or more individuals, but all of them must be alive at the time the trust is established. The income beneficiaries can be a class of persons, i.e., all my children, but the class must be limited to living and ascertainable members. The Church can be named to receive some of the payout, but the trust must have at least one non-charitable beneficiary. Payments can be made for a fixed term of years to individuals, corporations or noncharitable trusts, or to non-charitable trusts for the lifetimes of financially disabled or incompetent persons.

Term-of-years trusts can last no more than 20 years; trusts for the lives of beneficiaries may last much longer.

Payments can be made jointly to multiple income beneficiaries, then continue for the survivor(s), or be made to one person alone, then continue for a survivor: "Pay the unitrust amount to John for his life and then to Mary for her life." The trust document can provide that an independent trustee may sprinkle the yearly payment among a group of beneficiaries. This power allows the trustee to vary the amount of payout to each beneficiary from year to year as situations change.

Payments can be made to one or more persons for life (a husband and wife, for example), then to others (e.g., children), for a fixed term of years. Technically, the trust must pay children for their lifetimes or a term of years, whichever is shorter. Payouts must be made at least annually, but quarterly payments are the most common. In the case of a testamentary CRT, the payout may be deferred until a reasonable time after the close of the year in which the trust is fully funded.

Who Can Be Remainder Beneficiaries?

Both public charities (such as the Church) and private foundations can be named as remainder beneficiaries of CRTs, but including private foundations may produce unfavorable deduction results. The trust document must provide that if the designated charitable remainderman is not a qualified charitable organization at the time any amount is to be paid to the remainderman, the payments will be made to either (1) stated alternative qualified organizations or (2) a qualified charitable organization chosen by the trustee. Donors may retain the right to revoke a charity as remainderman and name others.

Who Can Serve as Trustee?

The Christian Science Trustees for Gifts and Endowments serves as the trustee for charitable trusts established. The law permits, however, that the following can serve as trustee of a charitable remainder trust: (1) a commercial trustee, such as a bank trust department, but minimum required funding amounts are often $500,000 or more; (2) the charitable remainderman, if permitted by the organization's charter and bylaws; (3) an unrelated third person; (4) the donor – however this may be risky if the donor retains an inappropriate interest or power in the trust that would cause the trust to be disqualified as a grantor trust (a sprinkling power, for example).

The Christian Science Trustees for Gifts and Endowments will serve as trustee where the Church is the irrevocable beneficiary and the trust is funded with a minimum of $150,000.

What Can't You Do with a Unitrust?

A charitable remainder trust is subject to special penalty taxes (private foundation excise taxes) if the trust engages in certain prohibited activities. The trust instrument must specifically prohibit the trustee from engaging in these activities or the trust will be treated as a taxable trust. The most important prohibition is self-dealing, which is generally defined as the use of trust assets to benefit the trust grantor or close family members (disqualified persons). Self-dealing includes a sale or lease of property between the grantor and the trust, or the transfer of mortgaged property to the trust. If a charity receives any part of the trust income, the trust is liable under rules prohibiting excess business holdings, jeopardizing investments and taxable expenditures.

Gift and Estate Tax Consequences of CRTs

Donors who establish charitable remainder trusts and name another person as income beneficiary (or as a joint or survivor beneficiary) are actually making two gifts: one to the Church and one to the other person. Our gift is nontaxable because of the gift tax charitable deduction. The gift to the income beneficiary is taxed based on the value of that person's income interest. The gift is eligible for the $14,000 annual exclusion if payments start immediately. If the donor keeps the right to revoke a survivor beneficiary's income interest by will, the gift will be incomplete and nontaxable for gift tax purposes. Donors are required to file Form 709 (gift tax return) for all CRTs, even where the donor is the only income beneficiary. A spouse who establishes a charitable remainder trust for the other spouse (or as a joint and survivor arrangement for both spouses) escapes gift tax because of the unlimited gift tax marital and charitable deductions. Gift tax returns are required, nonetheless, and the marital deduction will not be available if the trust has another beneficiary who is not a spouse.

Charitable remainder trusts that make payments only to the donor pass free of estate tax, thanks to the estate tax charitable deduction. CRTs that include spouses as beneficiaries qualify for the unlimited estate tax marital deduction, but only where the surviving spouse is the sole noncharitable beneficiary. A CRT established during life for a nonspouse gives rise to an adjusted taxable gift in the donor's estate. If the donor and a nonspouse are both beneficiaries, the entire trust value is included in the donor's estate, which is entitled to an estate tax charitable deduction measured by the surviving beneficiary's current age and the value of the trust assets. If a donor sets up a testamentary CRT for a nonspouse, the estate gets a deduction based on the beneficiary's age at the donor's death, the payout amount and the value of the trust assets.

Advantages of Charitable Remainder Trusts in Estate Planning

How does a charitable remainder trust fit into an estate plan? For unmarried and widowed men and women, the testamentary charitable remainder trust can save estate taxes by giving rise to a charitable deduction, even though the donor's family receives exclusive benefits from the trust for life or a term of years. Income tax savings may be achieved by leaving tax-burdened assets such as United States savings bonds or retirement plan assets to testamentary charitable trusts.

The charitable deduction is based upon the age of the income beneficiary at the time of the donor's death and the amount of income to be paid from the trust. Estate tax savings mean more of the estate is available to provide an income to the family. The trust potentially increases the funds available to provide income to the primary beneficiary of the estate, where the donor did not have the unlimited marital deduction. The charitable trust permits a person to confer benefits on the Church without lessening the security he or she wants to provide for family members. This is true even for the estates of married couples.

Selecting Assets to Fund Charitable Remainder Unitrusts

Donors who are considering a charitable remainder trust should give careful thought to what kind of property to place in the trust. Generally speaking, donors should not use property that (1) will cause the trust to have unrelated business taxable income, or (2) could result in a private foundation excise tax to be imposed. Transfers of debt-encumbered real estate will disqualify a charitable remainder trust, and donors should be aware that deductions for gifts of tangible personal property will be reduced and postponed until the item is sold from the trust. Transfer of S corporation stock to a charitable remainder trust will terminate the company's S status.

Real estate that is not subject to a mortgage can be excellent for funding a unitrust and sometimes an annuity trust (careful planning is needed to ensure the trust can make the required annuity payments). As noted earlier, office buildings and apartments that have been depreciated can be sold and reinvested within the trust without loss to capital gains taxes as high as 25% on the depreciation recapture portion.

A personal residence is suitable for transfer to a charitable remainder trust, but not if the donor wishes to continue living in the house. The prohibition against self-dealing would be violated if the donor continued using the house rent free, and probably would be violated even if a reasonable rent were charged, because the regulations forbid a lease of property by a charitable remainder trust to a disqualified person.

Publicly traded securities that have appreciated in value are ideal for funding a charitable remainder trust. Unlike closely held stock, these shares are freely transferable and generally pose no problems under the private foundation rules. Donors do not realize capital gain or net investment income upon the transfer to the trust because the transfer is not considered a sale or exchange. The trustee may sell the stock without causing the donor or the trust to incur current capital gains or net investment income tax, enabling the trustee to construct a diversified portfolio, investing for higher yield or tax-favored income, such as qualified dividends. Income beneficiaries eventually may report capital gain income from the sale of appreciated assets by the trust, under the four-tier system of trust taxation. But such gains typically are taxed at low rates.

Closely held stock may be transferred to a charitable remainder trust, but practical problems may arise: Is there a ready buyer for the shares? Is redemption of the stock from the corporation a possibility? Note that if charity is named to receive any portion of the trust income, the excess business holdings prohibition may apply.

Case Studies in Charitable Remainder Trusts

Tax-favored retirement savings. Many high-income professionals and executives are looking for tax relief during their years of high income and for a supplementary retirement savings vehicle that permits tax-free growth of their nest egg. The Retirement Unitrust, sometimes referred to as a Charitable IRA, can be a useful planning tool for such individuals – assuming they also have a motivation to provide substantial benefit to a charitable organization. The tax laws do not recognize a creature called a deferred payment charitable remainder trust. But it is possible to set up such an arrangement (or a reasonable facsimile thereof) through a flip unitrust. Such a trust could provide:

- An income tax deduction for part of the funds or property transferred to the trust, based on the age of the grantor at the time of contribution and the amount of income retained (minimum 5%).

- Deferral of at least a portion of the trust income until the grantor retires. Principal could grow more rapidly because the trust is tax exempt.

- Payment of substantial income after retirement, reflecting rapid growth of principal within a tax-exempt trust – and perhaps make-up of payment deficiencies during years the grantor was receiving little or no trust income.

- An important gift to the grantor's charity when the trust ends.

The trustee would invest initially in growth stocks, growth mutual funds or other investments (some have suggested zero-coupon bonds) that will swell the trust principal but pay very little income until the grantor retires.

> Example: Don, a young man in mid-career, transfers assets worth $100,000 to a net-income unitrust that will pay him the lesser of the trust's net income or 5% annually. The trust contains a "flip" provision that will cause the trust to change to a standard unitrust in the year following his 69th birthday. In the year he sets up the trust, Don may be able to deduct a charitable contribution of approximately $23,486 (4.0% AFR). The trustee invests entirely in growth stock that is expected to appreciate in value by 9% a year. Don's trust will have grown to $862,300 by the time he retires at age 70 (returns based on historical standards). By then he will enjoy 5% annual payments of nearly $43,115 that will be part tax free, part capital gain, assuming the trustee sells just enough growth stock each year to make the 5% payout.

Note: If Don wishes, he can add even more each year to his "retirement unitrust" – $25,000, for example – and receive additional deductions and even more income.

Supplemental College Funds for Grandchildren. CRTs can be established to pay income to children or grandchildren who are in college – subject to the kiddie tax. The so-called "kiddie tax" threshold is $2,000 for 2013 (investment income over that amount is taxed at the kids' parents' tax rates. This is affected by the 2007 Small Business and Work Opportunity Act, which extended the kiddie tax to children age 18 and below (formerly 17 or younger) and to full-time college students under age 24, effective after 2007, unless a student's earned income exceeds half of his or her support.

How would an education unitrust work? Donors with young grandchildren could establish term-of-years charitable remainder unitrusts equipped with sprinkling provisions that allow the trustee to bestow income only on those grandchildren who are attending college. (The donor cannot serve as trustee if there is a sprinkling power, or the donor has the ability to change the trustee.) Donors receive income tax charitable deductions and avoid capital gains taxes if the trust is funded with appreciated assets. The trust could be structured as a flip unitrust, with the trigger event being a particular event or date preceding the year the oldest child was expected to matriculate. So the trust might be established as a 20-year net income unitrust when grandchildren were ages two, five, eight and nine and invested primarily for growth until the oldest grandchild enters the 12th grade (a triggering event). The following year the trust would flip to become a standard payment unitrust, and start making unitrust payments to the oldest grandchild, then to other grandchildren, at the trustee's discretion.

Under earlier law, the college unitrust arrangement produced trust income that would be taxed at the beneficiaries' relatively low rates, assuming they were past the age of 17 and therefore not subject to the kiddie tax rules As noted earlier, however, the parents' rates apply to trust income (above $2,000) of full-time college students under age 24. Can the college unitrust still work? The answer should be yes, if the trust is invested to provide favorably taxed income.

A college unitrust, invested to generate primarily long-term capital gains and qualified dividends, can be extremely tax-efficient even where the beneficiaries' parents are in a 33% or 35% federal tax bracket. Such a plan would enable beneficiaries to enjoy income taxed at a 15% rate, under current law. In some cases, part of the beneficiaries' payout may be tax-free return of corpus, reducing tax rates on the unitrust amount to under 15%.

Suppose a grandfather transfers a $200,000 stock portfolio with an aggregate basis of $100,000 to an 8%, 20-year college unitrust, with a flip provision. The stocks earn 1% dividends and grow at an annual rate of 8%, so that after nine years the trust grows to $400,000 (dividends are paid out annually but capital gains are not). The trust flips to become a standard payout unitrust in Year 10, when the oldest grandchild, now age 18, starts receiving 8% of $400,000. The stocks pay 1% dividends ($4,000) annually so the trustee must sell $28,000 of stock the first year to pay the grandchild the remaining $28,000 due him (a $32,000 total unitrust amount). The sale results in $21,000 of long-term gain and $7,000 tax-free return of corpus (basis). Under current law, $1,900 of capital gains/dividends would be tax free, assuming the grandchild is in a 15% tax bracket; $7,000 would be tax-free return of corpus and the remaining $23,200 of payout would be taxed at the 15% rate applicable to capital gains and dividends . . . an average 10.9% tax rate. It should be mentioned that the donor also receives a charitable deduction of about $40,000 in the year the trust is created.

Stock in Family Business Fits in CRT. A recent IRS ruling illustrates how closely held stock (often the most valuable asset owned by a donor) can be used to fund a charitable remainder trust. Morton funded a charitable remainder unitrust with stock in his company, and now the unitrust owns 62% of the shares – Morton has 5% and his company's employee stock ownership plan owns the remaining 33%. His company plans to redeem for cash a certain number of shares held by the shareholders (the company has only one class of stock). The stock will be redeemed at fair market value as determined by an independent appraiser. Will self-dealing occur when the unitrust trustee has its shares redeemed by Morton's company? The IRS said no, because all shareholders are subject to the same redemption offer and the trust will receive fair market value.

Flexibility: Hallmark of the Charitable Remainder Trust

Donors who establish charitable remainder trusts have a broad array of choices as to the objectives, management and operation of their gift plan. They can:

1. Choose fixed or variable payments (annuity trust or unitrust);

2. Name themselves and/or loved ones as income beneficiaries;

3. Decide whether the trust will continue for one or more lives or a specific length of time (up to 20 years), or perhaps life plus a term of years;

4. Choose a net-income or flip unitrust arrangement that has the potential to defer payment of some or all trust income until some future time;

5. Designate qualified contingencies that will terminate the trust early on the happening of specified events, with trust assets passing immediately to the Church;

6. Provide that the trust will be continued (or established) upon their passing, to provide financial security and freedom from money management responsibilities, for loved ones;

7. Arrange for wealth replacement of assets transferred during life to a CRT, through the purchase of life insurance (an irrevocable life insurance trust could be considered where the donor has a taxable estate);

8. Select the assets to fund the trust, particularly tax-burdened investments such as long-term capital gain property. For testamentary CRTs, income in respect of a decedent such as retirement accounts, United States savings bonds, stock options and accounts receivable can have favorable tax results.

How to Proceed

If you are interested in arranging a charitable remainder trust, please e-mail, call or write our office.

We are pleased to advise you:

1. The lifetime trust payments you may expect
2. An estimated income tax charitable deduction
3. Potential capital gains tax savings, if your trust is funded with stocks or other assets

You will need to share with us:

1. The type of asset you are considering to fund the trust
2. Whether you prefer fixed annual payments (the annuity trust) or variable payments (the unitrust)
3. The amount of annual income you desire (generally 5% to 7%)
4. The value of the cash or assets you would use to fund the trust
5. Your cost basis in investment assets that will be transferred to the trust
6. The birth dates of the people who will be receiving trust payments

You can contact our office at philanthropy@csps.com, by phone at 1-800-288-7155, extension 3288, or write to us at the address below. We look forward to hearing from you.

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