



Charitable Remainder Trusts

LIFE INCOME GIFTS

In the simplest terms, a “life income gift” is a plan that allows a donor to make a contribution to charity and receive an income in return. Depending upon the plan, the income may be fixed or variable and it can go on for one or more lifetimes, a term of years, or a combination of the two. Later we will explore a number of specific plans, however, they have the following features in common:

- are irrevocable once the contribution has been made
- provide a current income tax deduction for the calculated value of the charitable gift
- can be made during lifetime or included in a Will or other testamentary instrument
- subject to both Federal and state laws

Life income gifts offer distinct advantages—and disadvantages—for both the donor and the charity:

- **For the donor** – the ability to receive income, avoid capital gains tax, and shift investment strategies are advantages, however donors must also consider that these gifts are irrevocable and there is very little flexibility should the donor wish to make changes after the gift is made
- **For the charity** – the irrevocability of these gifts is an advantage compared to other planned gifts which can be changed or even revoked without the charity being aware, however the charity must consider that it will need to establish relationships—sometimes lifelong—with the donor and beneficiary and take responsibility for fiscal and fiduciary matters

TYPES OF LIFE INCOME GIFTS

Charitable gift annuity

- Money, property, or other assets are irrevocably given to a charity now in exchange for a contractual promise to pay a fixed amount each year to one or two beneficiaries
- The amount of payment is set at the time the gift is made and cannot be changed
- One or two annuitants are named at the time the gift is made and cannot be changed
- The date of the first annuity payment may be delayed (deferred payment gift annuity)
- Payments are backed by the charitable organization that issues the gift annuity

Charitable remainder trust

- Money, property, or other assets are irrevocably transferred to a trustee with instructions to pay income to one or more income beneficiaries for a period of time and then to transfer the remainder in the trust fund to charity
- Two types:
 - **Annuity trust** – pays a fixed dollar amount to the income beneficiaries
 - **Unitrust** – pays a fixed percentage of the value of the trust fund to the income beneficiaries
- Trustee may be the charity, a trust company, an individual, or others
- Payout method (annuity or percent of trust value), rate or amount of payout, income beneficiary(ies), and other terms of trust are set at the time the gift is made and cannot be changed

Pooled income fund

- Many donors irrevocably contribute money, property, or other assets to a pooled investment fund operated by a charity
- Income beneficiaries are paid a share of the fund’s net income proportionate to the value of their contribution
- As income beneficiaries die, their share of the fund is withdrawn for use by the charity

BY THE NUMBERS

Since a life income gift donor contributes only a partial interest (the donor retains the right to income), the income tax charitable deduction is less than the fair market value of the property or money contributed. Following is a brief overview of the calculation of the deductible amount:

- In general, the charitable deduction is for the estimated value of the contribution to the charity—the value of the money or property contributed, minus the value of the right of the income beneficiary to receive income
- Formulae, factors, other variables, and a discount rate¹ are specified by U.S. Treasury Regulations
- Charitable Gift Annuity
 - Begin with the value of money or the fair market value of property or other assets contributed

¹ The “Applicable Federal Rate” (AFR), sometimes called the “Charitable Midterm Federal Rate” (CMFR) or the “7520 Rate,” is the IRS discount rate used to determine the charitable deduction for most planned gifts. It is the assumed rate of return that the gift assets will earn during the gift term. The IRS discount rate changes monthly. It equals 120% of the annualized average yield of U.S. Treasury instruments over the past 30 days that have remaining maturities of 3-9 years. The higher the IRS discount rate, the higher the deduction for charitable remainder trusts and gift annuities, and the lower the deduction for charitable lead trusts and retained life estates. Fluctuations in the IRS discount rate affect unitrust deductions far less than annuity trust and gift annuity deductions.

- Then subtract the present value of a annuity (which is the value retained by the donor)
- The remainder is the amount of the charitable deduction
- Charitable Remainder Trust or Pooled Income Fund
 - Begin with the value of money or the fair market value of property or other assets contributed
 - Then subtract the present value of the income expected to be paid to the beneficiaries (which is the value retained by the donor)
 - The remainder is the amount of the charitable deduction
- General rules of thumb:
 - **Older beneficiaries, lower payouts = larger deduction** – the older the beneficiary and/or the lower the payout, the larger the deduction because the charity can be expected to pay less to the income beneficiary thus leaving more for charity
 - **Younger beneficiaries, higher payouts = smaller deduction** – the younger the beneficiary and/or the higher the payout, the smaller the deduction because the charity can be expected to pay more to the income beneficiary. It is also true that more beneficiaries leads to a smaller deduction.
- Technology to the rescue!
 Fortunately for development officers, readily available software can provide quick and accurate calculations. Programs such as *Planned Giving Manager* software by PG Calc[®] can calculate deductions and compare different gift plans and options (e.g., sell and reinvest versus make a contribution). In addition, the software can model financial results over time and prepare appealing presentations and formal documentation.

CHARITABLE REMAINDER TRUSTS

There are many different types of trusts, some with highly specialized uses. In general, trusts function as follows:

- The grantor (or donor) transfers money or property to a trustee along with a legal instrument providing instructions for operation of the trust (the trust agreement)
- The trustee:
 - Holds, sells, invests and reinvests the trust's assets
 - Makes payments to the income to beneficiaries as directed in the trust agreement
 - Then, when the trust ends, distributes the remainder as directed in the trust agreement

A trust can be *inter vivos* (set up during grantor's lifetime) or testamentary (created after death through the Will of the grantor).

Trusts are generally subject to state law.

A charitable remainder trust (CRT) is a special type of trust which is tax-exempt under Federal law. A charitable remainder trust separates the right to receive the income (the income interest) from the right to eventually own the trust assets themselves (the remainder interest). In order to qualify as a CRT, a trust must meet several specific requirements. Among them are:

A sample charitable remainder unitrust document can be found in the Appendix.

- Donor contributes to charity an irrevocable right to the remainder interest
- May not be perpetual, but can last for one or more lifetimes, a term of years (not to exceed 20), or a combination of lifetimes and years, set at the time the trust is created
- The payout percentage for a unitrust must be not less than 5% and the payout amount for an annuity trust must not be less than the equivalent of 5% of the contribution
- The trust agreement must include certain specific provisions, including:
 - Acknowledgement that the trust is irrevocable
 - At least one of the income beneficiaries must be an individual
 - Payments to the income beneficiary must be made at least annually
 - Income interest must be an “annuity trust” or “unitrust” interest
 - Remainder beneficiary must be a charitable organization

There is no capital gains tax on the transfer of capital gain property to the trust and, since charitable remainder trusts are tax exempt entities, the trust does not pay capital gains tax if it sells the appreciated property.

CHARITABLE REMAINDER BENEFICIARY

As noted above, the remainder beneficiary of a qualified charitable remainder trust must be a charitable organization. However, at the time the trust is created the donor may reserve the right to change the specific charity that will receive the remainder. As a consequence, although the donor’s contribution to the charitable remainder trust is irrevocable, your organization’s position as remainder beneficiary may not be irrevocable.

The sample trust document provided by the Internal Revenue Service in the Appendix names one charity irrevocably (see Section 4). This provision could instead reserve for the right to change the specific charity, in which case your organization might or might not receive the remainder. Note that in either case the next sentence ensures that the remainder will be distributed only to a charity even if the donor fails to name a charitable remainder beneficiary or names a charity that is not in existence when the trust ends.

CHARITABLE REMAINDER TRUST TYPES

There are two types of charitable remainder trusts, which differ in how the amount paid to the income beneficiary is determined:

- **Annuity trust** pays a fixed dollar amount to the income beneficiary. The amount may be determined as a percentage of the amount contributed, but once the dollar amount is

determined, it never changes. (For this reason, an annuity trust *may not* accept additional contributions.)

- **Unitrust** pays a fixed percentage of the value of the trust fund, as re-valued each year. Once the percentage is set, it cannot be changed. However, since the value of the trust fund changes each year, the actual amount paid to the income beneficiary will vary. A unitrust *may* accept additional contributions.

Further, there are four types of charitable remainder unitrusts. In each case the trustee values the trust assets each year and applies the unitrust percentage in order to determine the unitrust amount for that year. However, the actual amount paid to the income beneficiaries is determined differently depending upon the type of unitrust.

- **“Basic,” “Standard,” “Type I,” or “SCRUT”** – the trustee pays the unitrust payment amount and can distribute principal if required to make the payment
- **“Net Income,” “Type II,” or “NICRUT”** – the income beneficiary receives the unitrust payment amount or the trust’s net income, whichever is *less*, but the trustee must not distribute principal—for example, if the unitrust payout rate is 5% but the trust earns only 4%, the beneficiary will receive the smaller amount
- **“Net Income with Make-Up,” “Type III,” or “NIMCRUT”** – pays the unitrust payment amount or the trust’s net income, whichever is *less* (just like the Net Income Unitrust), but keeps track of shortfalls and pays make-up payments in years when there is excess income (not likely to occur at today’s very low interest rates)
- **“Flip Trust”** – begins as either a “Net Income” or “Net Income with Make-up” type, but then transforms into a “Standard” type upon the occurrence of some event in the future, such as the sale of a piece of real estate or a specific date.

Note: | With the exception of a “Flip” provision, a unitrust cannot change its type once it is created.

INCOME TAXES TO BENEFICIARIES

Income paid to the beneficiary of a charitable remainder trust is subject to taxation depending upon the source of the funds the trustee uses to make the payment. Since the charitable remainder trust itself is tax-exempt, it pays no income taxes. Essentially, the trust passes through the income tax obligation when it makes distributions to its income beneficiaries. In other words, the dollars paid to the income beneficiary retain the same tax character they would have had if the trust had been required to pay income tax itself. For example, the trust can collect interest income and pay no income tax, however if the trust then distributes that interest income to an income beneficiary, the beneficiary will have to pay income tax on the interest.

The trustee must follow a strict set of rules to determine which funds are used to make payments to the income beneficiaries. The so-called “Four Tier Payout Rule” specifies that the trustee must payout income in the following order:

- First, all “net income” (interest and dividends) and any undistributed net income from previous years—which is taxed as ordinary income to the beneficiary

- Second, all realized long term capital gains income and any undistributed long term capital gains income from previous years—which is taxed as capital gain income
- Third, all tax-exempt income and any undistributed tax-exempt income from previous years—which is tax-exempt to the beneficiary
- Finally, principal of the trust—which is tax-free to the income beneficiary

In categories that include more than one kind of income, the income taxed at the highest rate is distributed first. For example, bond interest and qualified dividends are both forms of ordinary income, but bond interest is taxed at a higher rate than qualified dividends, so all of the bond interest will be distributed before any of the qualified dividends.

Example: a \$25,000 payment from a unitrust might consist of four types of income

Dividend and interest (ordinary income taxed up to 39.6%)	\$7,500
Long-term capital gain income (taxed up to 20%)	\$12,500
Tax-exempt income (tax free)	\$2,500
Return of principal (tax free)	\$2,500
TOTAL	\$25,000

For a beneficiary in the 28% marginal income tax bracket and the 15% long-term capital gain tax bracket, the income tax due on this distribution would be \$3,975 ($\$7,500 \times 28\% + \$12,500 \times 15\%$) compared to \$7,000 ($\$25,000 \times 28\%$) if the entire payment had been taxed as ordinary income.

CAVEAT REGARDING SECURITIES LAWS

Ambiguity regarding the application of securities laws to life income gifts and the necessity to register certain plans with the Securities Exchange Commission as investment securities was resolved by the Philanthropy Protection Act (1995), which exempts life income gifts from securities registration requirements provided that (among other things) full and complete disclosure is made to prospective donors prior to the making of a gift.

CHARITABLE REMAINDER TRUST EXAMPLES

Assume a donor, age 72, decides to create a charitable remainder unitrust which will pay him 5% of the value of the trust fund each year for the rest of his lifetime. Following is a summary of the results:

SUMMARY OF BENEFITS: 5% CHARITABLE UNITRUST

ASSUMPTIONS:	
Beneficiary Age	72
Cash Donated	\$500,000.00
Payout Rate	5%
Payment Schedule	quarterly 3 months to first payment
BENEFITS:	
Charitable Deduction	\$276,805.00
Estimated Income in first full year (future income will vary with trust value)	\$25,000.00
IRS Discount Rate is 1.8%	

SELECTING THE CHARITABLE REMAINDER TRUST PAYOUT PERCENTAGE

The selection of the charitable remainder payout percentage is a critical element in the creation of a successful charitable remainder trust. Donors are often inclined to select a high payout with the expectation that it will result in larger payments for the income beneficiaries. However, setting the payout too high can cause the trust to erode principal value which not only reduces the amount available for charity but can ultimately reduce the amount paid to the income beneficiaries.

The payout percentage must be set at the time the gift is made and cannot be changed later. By law the percentage cannot be less than 5% and cannot be so high that the resulting charitable deduction is less than 10% of the amount contributed. When discussing the payout with your donor, keep in mind the following points:

- A higher payout percentage reduces the value of the charitable deduction. Depending upon the IRS discount rate in effect at the time of the gift, a 1% increase in a unitrust payout amount can result in a 10% (or more) loss in the charitable deduction as illustrated in the table below:

Charitable Deduction for \$500,000 Contribution to a 5% Unitrust

Payout Rate:	5%	6%	7%	8%	9%	10%
One Life 72	\$276,805	\$248,865	\$224,605	\$203,475	\$185,015	\$168,830
Two Lives 72	\$220,855	\$188,995	\$162,170	\$139,535	\$120,400	\$104,180
IRS Discount Rate is 1.8%						

- If the unitrust payout percentage is set higher, the trustee may be forced to select riskier investments in order to produce an investment return sufficient to meet the payout percentage. Riskier investments can bring greater variability in the trust—higher highs, hopefully, but also lower lows.
- Finally, if the unitrust payout percentage is set much higher than the expected investment return (and the unitrust is not a net income type), the trust may be forced to consume principal in order to make the unitrust payments each year. The following graphs illustrate charitable remainder unitrusts with various payout rates, each earning a net total

return of 6%. The higher payout percentage has a dramatic negative impact on the remainder left for charity and, given enough time, can actually result in a smaller payment to the income beneficiaries.

LIFE INCOME PROJECTIONS

Sometimes it can be helpful to provide prospective donors with an illustration of the projected value of a charitable remainder trust over their lifetimes. Following is an example of a life income projection for a charitable remainder unitrust comparing various payout rates and assuming the same investment return in each case:

PROJECTED BENEFITS: CHARITABLE REMAINDER UNITRUSTS

ASSUMPTIONS:

Projection runs for 20 years.

Measuring life age 72.

Original principal is \$500,000. Cost basis is \$100,000.

Donor income tax bracket is 43.3%, 39.6% for tax savings, 23.8% for capital gains.

Beneficiary income tax bracket is 43.4%, 23.8% for long-term capital gains.

Net Total Return is 6%: 2% income and 4% appreciation.

Contributed assets are sold in first year.

	Charitable Unitrust 5%	Charitable Unitrust 7%	Charitable Unitrust 9%
1) Gross Principal	\$500,000	\$500,000	\$500,000
2) Average Annual Beneficiary Payment	\$27,524	\$31,866	\$34,215
3) Charitable Deduction	\$276,805	\$224,605	\$185,015
4) Income Tax Savings	\$109,615	\$88,944	\$73,266
5) After-tax Cost of Gift	\$390,385	\$411,056	\$426,734
6) Total Before Tax Beneficiary Payment	\$550,475	\$637,326	\$684,308
7) Total After-tax Beneficiary Payment	\$376,305	\$449,952	\$491,638
8) Projected Remainder to Charity	\$610,095	\$408,953	\$271,897
9) Total Benefit (7 + 8)	\$986,400	\$858,905	\$763,535
IRS Discount Rate is 1.8%			

Finally, donors might wish to consider a charitable remainder trust as an alternative to selling an appreciated property, paying the capital gains tax, and reinvesting the proceeds. The following example compares the charitable remainder trust with selling and reinvesting (and making no gift at the present time). This example makes the same investment assumptions for both alternatives. Note that the charitable remainder trust results in greater income and a larger amount remaining. The reason is that the capital gains tax is not paid and therefore the trust begins with a larger amount of capital to invest.

PROJECTED BENEFITS: KEEP / SELL / UNITRUST

ASSUMPTIONS:

Projection runs for 20 years.

Measuring life age 72.

Original principal is \$500,000. Cost basis is \$100,000.

Donor income tax bracket is 43.4%, 39.6 for tax savings, 23.8% for capital gains.

Beneficiary income tax bracket is 43.4%, 23.8% for capital gains.

	Kept Intact	Sold and Reinvested	Unitrust 5%
1) Gross Principal	\$500,000	\$500,000	\$500,000
2) Net Principal	\$500,000	\$404,800	\$500,000
3) Average Annual Beneficiary Payment	\$14,889	\$22,283	\$27,524
4) Charitable Deduction	0	0	\$276,805
5) Income Tax Savings	0	0	\$109,615
6) Capital Gains Tax	0	\$95,200	0
7) After-tax Cost	\$500,000	\$500,000	\$390,385
Investment Income	2%	5%	2%
Investment Capital Appreciation	4%	1%	4%
8) Total Before Tax Beneficiary Payment	\$297,781	\$455,665	\$550,475
9) Total After-tax Beneficiary Payment	\$168,544	\$252,246	\$376,305
10) Total Left to Heirs	\$1,095,562	\$493,933	0
11) Remainder to Charity	0	0	\$610,095
12) Total Benefit (9 + 10 + 11)	\$1,264,105	\$746,179	\$986,400
IRS Discount Rate is 1.8%			

(Adapted from the book *Planned Giving in a Nutshell*. Used with permission of the publisher.)

Appendix: Sample Charitable Remainder Trust Agreement

NOTE: DO NOT USE THIS FORM AS-IS. It is presented for illustration only.
Consult with legal counsel to develop a trust agreement suitable for your purposes.

<Name> Charitable Remainder Trust

On this <date> day of <month, year>, I, <donor name> (hereinafter “the Donor”), desiring to establish a charitable remainder unitrust within the meaning of Rev. Proc. 2005-52 and §664(d)(2) of the Internal Revenue Code (hereinafter “the Code”), hereby enter into this trust agreement with <trustee name> as the initial trustee (hereinafter “the Trustee”). This trust shall be known as the <name> Charitable Remainder Unitrust.

1. Funding of Trust.

The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

2. Payment of Unitrust Amount.

In each taxable year of the trust during the unitrust period, the Trustee shall pay to <beneficiary name > (hereinafter “the Recipient”) a unitrust amount equal to <number> percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter “the valuation date”). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient’s death. The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

3. Proration of Unitrust Amount.

For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 5.

4. Distribution to Charity.

At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient under the terms of this trust) to <charity name> (hereinafter “the Charitable Organization”). If the Charitable Organization is not an organization described in §§170(c), 2055(a), and 2522(a) of the Code at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in §§170(c), 2055(a), and 2522(a) of the Code as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee’s sole discretion.

5. Additional Contributions.

If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be <same number as paragraph 2> percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day in such taxable year or the last day of the unitrust period. In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

6. Deferral of the Unitrust Payment Allocable to Testamentary Transfer.

All property passing to the trust by reason of the death of the Donor (hereinafter “the testamentary transfer”) shall be considered to be a single contribution that is made on the date of the Donor’s death. Notwithstanding the provisions of paragraphs 2 and 5 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor’s death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor’s death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the taxable year in which the testamentary transfer is completed, the Trustee must pay to the Recipient (in the case of an underpayment) or receive from the Recipient (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under § 664 of the Code prescribe for this computation.

7. Unmarketable Assets.

Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter “unmarketable assets”), by either (a) obtaining a current “qualified appraisal” from a “qualified appraiser,” as defined in §1.170A-13(c)(3) and §1.170A-13(c)(5) of the Income Tax Regulations, respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an “independent trustee,” within the meaning of §1.664-1(a)(7)(iii) of the Income Tax Regulations.

8. Prohibited Transactions.

The Trustee shall not engage in any act of self-dealing within the meaning of §4941(d) of the Code, as modified by §4947(a)(2)(A) of the Code, and shall not make any taxable expenditures within the meaning of §4945(d) of the Code, as modified by §4947(a)(2)(A) of the Code.

9. Taxable Year.

The taxable year of the trust shall be the calendar year.

10. Governing Law.

The operation of the trust shall be governed by the laws of the State of <name>. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under §664(d)(2) of the Code and the corresponding regulations.

11. Limited Power of Amendment.

This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of §664(d)(2) of the Code.

12. Investment of Trust Assets.

Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

13. Definition of Recipient.

References to the Recipient in this trust instrument shall be deemed to include the estate of the Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

