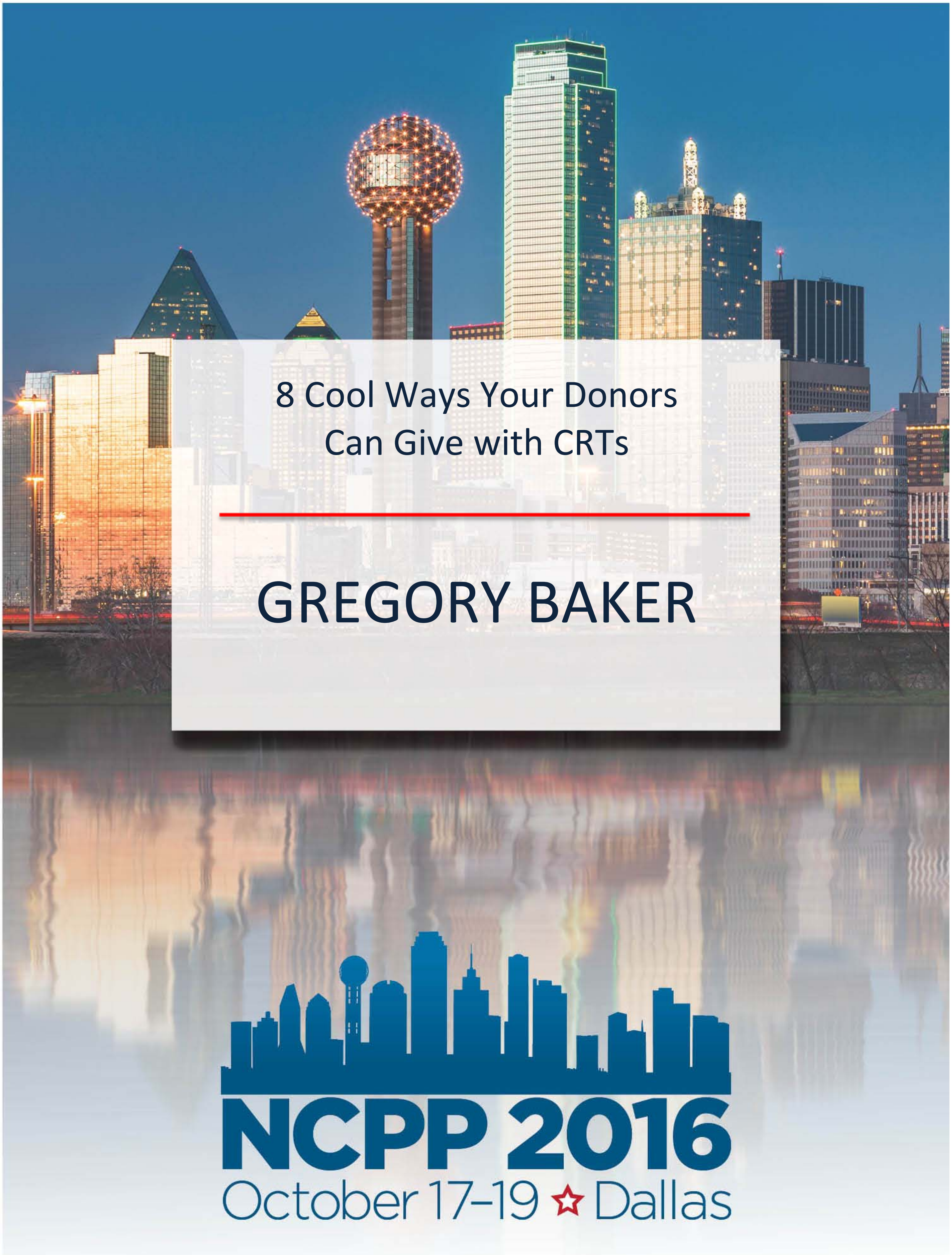

8 Cool Ways Your Donors Can Give with CRTs

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NCPP 2016
October 17–19 Dallas

8 Cool Ways Your Donors Can Give Using Charitable Remainder Trusts

October 2016

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BAKER'S DOZEN OF CRT TRAPS

1. Not knowing what you are doing and not getting competent help
2. Transferring an IRA to a CRT during your donor's life or Transferring S-corporation shares to a CRT
3. Forgetting that CRTs are (mostly) IRREVOCABLE
4. Failing to build sufficient flexibility in your donor's CRT
5. Placing too much emphasis on high payout rates
6. Failing to Properly Match the CRT format with the proposed contributed asset or investment plan
7. Using the Donor's EIN for the CRT
8. Failing to understand when the Assignment of Income doctrine does and does not apply
9. Permitting acts of Self-Dealing
10. Blindly using documents or Giving "sample" CRT documents to a charity or donor
11. Blindly adding children, ex-spouses, etc. as income beneficiaries
12. Naming a noncharitable beneficiary class that lasts for a lifetime
13. Failing to recognize a CRT opportunity when it is staring you in the face

8 COOL WAYS YOUR DONORS CAN GIVE USING CHARITABLE REMAINDER TRUSTS

By
Gregory W. Baker, J.D., ChFC®, CFP®, CAP

Introduction

A Charitable Remainder Trust (CRT) can enable donors to realize charitable goals that would otherwise seem beyond their reach. In its simplest form, a CRT is a giving tool that permits a donor to make a gift to charity while retaining a cash flow for life. The CRT is a powerful combination of tax, finance, charitable and estate planning made possible by dedicating **today** a gift to charity in the future while reserving a lifetime cash flow.

A CRT is an irrevocable agreement in which a donor transfers assets to a trust in exchange for an income interest[1]. 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/or private foundations.

By remembering these CRT features when discussing a donor's goals, gift planners can create more CRT plans.

I. 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 an agreement with the trustee to transfer certain assets to be managed and maintained by the trustee. The agreement is documented by a written instrument called a trust instrument, trust agreement, or declaration of trust. 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 income tax.[2]

The Donor. Any individual, corporation, partnership, limited liability company (LLC), or trust can be a donor. 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.[3]

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[1] In some cases, the income interest may be designated to a person or persons other than the donor and the donor's spouse.

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

[3] A sampling of Private Letter Rulings that permit non-natural person entities to be a CRT donor and income beneficiary includes: C-Corporation – 9205031 and 8102093; S-Corporation – 200644013 and 9340043; LLC – 199952071; Partnership – 9410021; and Trust – 9821029.

The Trustee. The CRT trustee may be an individual, including the donor, [4] 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 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[5] to be named as a CRT's income beneficiary so long as at least one income beneficiary is not a charitable organization.[6] For example, the income beneficiary could be an individual, corporation, partnership, LLC, or trust. However, if any non-natural person beneficiary *could be* a noncharitable 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.[7,8] 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., a donor advised fund, the donor's alma mater, a religious institution, the United Way, etc.) or 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.[9] 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

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[4] See Revenue Ruling 77-285.
[5] See IRC §7701(a)(1), which defines a "person" as an individual, trust, estate, association, company, corporation, or partnership.
[6] 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.
[7] See PLRs 9323039 and 200108035 for a discussion of some of the issues surrounding naming a charity as a CRT income beneficiary.
[8] 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).
[9] See Revenue Rulings 76-7 and 76-8.

remedied by using life insurance held in an irrevocable life insurance trust, often called a wealth replacement rust, 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.

II. 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)[10] or (b) a fixed percentage of the trust's assets revalued annually (a Charitable Remainder Unitrust, or CRUT).[11] 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:

- **S**tandard **C**haritable **R**emainder **U**ni**t**rust (SCRUT). As described above, a SCRUT must pay a *fixed percentage* of the trust's assets revalued annually.[12] Therefore, as the value of the trust's assets rises or falls on the annual valuation date, payments to the trust beneficiaries will rise or fall.
- **N**et-**I**ncome with **M**ake-up **C**haritable **R**emainder **U**ni**t**rust (NIMCRUT).[13] 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[14] and pay the *lesser* of these two amounts to the income beneficiaries.[15] 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[16] (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 C**haritable **R**emainder **U**ni**t**rust (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 lesser of the trust's accounting income or the fixed percentage unitrust amount to the income beneficiaries. In the second phase, following the occurrence of a predetermined triggering event, the trust switches, or "flips," to a SCRUT17 and pays out a fixed percentage of the trust's annual fair market

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[10] IRC §664(d)(1)(A).
[11] IRC §664(d)(2)(A).
[12] *Id.*
[13] Technically another variation is the **N**et-**I**ncome **C**haritable **R**emainder **U**ni**t**rust (NICRUT). Note that this version has no make-up provision.
[14] To determine a trust's accounting income, IRC §643(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.
[15] See IRC §664(d)(3) and Treas. Reg. §1.664-3(a)(1)(i)(b).
[16] See IRC §664(d)(3) and Treas. Reg. §1.664-3(a)(1)(i)(b)(2).
[17] See Treas. Reg. §1.664-3(a)(1)(i)(c).

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.[18] The change in the payout method commences on January 1st of the year following the triggering event.

Permissible triggering events[19] 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.

III. 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, and art and other tangible personal property. When combined with an ILIT, the CRT can solve many of a donors' 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.

IV. 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,

[18] Treas. Reg. §1.664-3(a)(1)(i)(c)(3).
[19] See Treas. Reg. §1.664-3(a)(1)(i)(c)(1), (d).

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 planner 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.

Gifts of Real Estate. The gift to a CRT of an interest in real estate has important tax and other legal ramifications. Such gifts require special handling. To assist with the unique aspects of real estate gifts, prospective donors and their professional advisors must do their best to uncover and resolve all "special handling" issues before they become major problems. Consistently using a thorough checklist can help gift planners uncover many of these issues **before** the property is contributed.

Real estate gift special handling issues come in many varieties. For example, a given parcel of realty can possess attributes that make it unfit for contribution to a charitable remainder trust in its present state. A very partial list of examples includes: questionable or defective title; mortgages, the payment of which by the trustee could ruin the trust's tax-exempt status; leases or uses that will generate unrelated business taxable income; a poor location, shape or other physical characteristics that render the property virtually unmarketable; a post-gift use or co-tenancy arrangement that would constitute prohibited "self-dealing"; the existence of legal restrictions that would impede or prevent future development; the existence of an outstanding sales agreement, sales contract or option to purchase; environmental defects/contamination; the existence of co-tenants whose intentions with respect to the property will run counter to those of the trust; and existing improvements to the land (or nuisances) that (i) require excessive management services and/or maintenance, and/or (ii) present an undesirable degree of premises liability. For these reasons, among others, contributions of real estate to a CRT should never be made without the thorough analysis and recommendation of independent legal counsel.

Gifts of Art and Tangible Property. Gifts of art and other tangible property to a CRT involve additional considerations. Generally, the income tax charitable deduction for such gifts is limited to the client's cost basis in the property.[20] The income tax charitable deduction is also delayed until the CRT sells or otherwise disposes the property.[21] 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. Further, if the charitable deduction claimed for the gift exceeds $20,000 for a gift of art, the client must attach the Qualified Appraisal to the tax return on which the deduction is claimed.

[20] See IRC §170(e)(1)(B)(1).

[21] See IRC §170(a)(3) and Treas. Reg. §1.170A-5(a)(1).

Gifts of Restricted Securities. Gifts to a CRT 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.

Gifts of S-Corporation Stock. 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 noncharitable 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).[22]

Gifts of Intellectual Property. The valuation of most gifts of intellectual property is difficult and the recipient charity's ability to harvest that value is questionable. Therefore, the rules changed in 2004 for claiming charitable deductions for gifts of intellectual property. Intellectual property is defined as any of the following: patents, copyrights, trademarks, trade names, trade secrets, know-how, some software and similar property.[23] These assets are defined as "Qualified Intellectual Property".[24] Donors may deduct the smaller of their cost basis or the fair market value of the Qualified Intellectual Property they give to charity. Additionally, if the donor contributes the Qualified Intellectual Property to a publicly-supported charity, the donor may request (near the time of the gift) that the charity report to the donor how much net income the charity earns from the gift during the 10 years following the gift.[25] The donor can deduct this net income on a sliding scale based on information reported by the charity to the donor and IRS on Form 8899. The sliding scale is depicted in the following table:

[22] See Revenue Ruling 92-48.
[23] See IRC §170(e)(1)(B)(iii).
[24] See IRC §170(m)(9).
[25] Additional deductions may be claimed for the shorter of 10 years following the gift or the remaining useful life of the Qualified Intellectual Property as of the gift date.

DONOR'S TAX YEAR	APPLICABLE PERCENTAGE
1	100%
2	100%
3	90%
4	80%
5	70%
6	60%
7	50%
8	40%
9	30%
10	20%
11	10%
12	10%
13	0%

The IRS Form 8899 is due one month after the end of the charity's fiscal year. As with most charitable gifts, the donor may only claim a deduction for giving to charity her entire interest in the property. This deduction system closely correlates the donor's charitable deduction with the actual value received by the charity from the gift. Net income received by the charity is defined as "Qualified Donee Income".[26]

> **Example**: Patricia Patent creates a patent for a better mousetrap and incurs $50,000 of cost in the process. Patricia contributes the patent to ABC Charity on August 31, 2012. Assuming the patent is appraised at more than $50,000, Patricia is eligible to claim a $50,000 income tax charitable deduction for her 2012 tax year. Although ABC Charity is a publicly-supported charity, Patricia does not notify ABC Charity that she intends to treat the patent gift as Qualified Intellectual Property; therefore, she may not claim any additional charitable deduction for her patent gift.

The donor cannot claim a double deduction for her basis in the Qualified Intellectual Property. Instead, the donor must reduce the net income reported on IRS Form 8899 by her cost basis.

> **Example**: Paula Tripp creates a patent for an even better mousetrap and incurs $35,000 of cost in the process. Paula contributes the patent to XYZ University on July 15, 2016. Assuming the patent is appraised at more than $35,000, Paula is eligible to claim a $35,000 income tax charitable deduction for her 2016 tax year. Additionally, because XYZ University is a publicly-supported charity and Paula notifies the charity she intends to treat the patent gift as Qualified Intellectual Property, she may claim additional charitable deductions based on the net income received by XYZ University. However, Paula may not deduct the first $35,000 (her cost basis) of XYZ University's income from the Qualified Intellectual Property. XYZ University earns $20,000 of net income from the patent in 2016 and $95,000 in

[26] See IRC §170(m)(3).

> 2017 and reports those amounts on IRS Form 8899 to Paula and the IRS. During 2016, Paula can only deduct her $35,000 cost basis. For 2017, Paula may claim additional deductions after XYZ University's total earnings from the patent exceed her $35,000 cost basis. Therefore, for 2017, Paula may claim an additional deduction of $80,000, which represents XYZ University's total earnings of $115,000 minus Paula's cost basis of $35,000. If XYZ University earned an additional $100,000 in 2018, Paula could deduct an additional 90% or $90,000 on her 2018 tax return.

Qualified Donee Income can be claimed as a deduction as though the donor made the charitable contribution in the year for which the Qualified Donee Income is reported by the charity.[27]

> **Example**: Peter Caruso creates a patent for the best mousetrap and incurs $45,000 of cost in the process. Peter contributes the patent to State University on August 28, 2016. Assuming the patent is appraised at more than $45,000, Peter is eligible to claim a $45,000 income tax charitable deduction for his 2016 tax year. Additionally, because State University is a publicly-supported charity and Peter notifies the charity he intends to treat the patent gift as Qualified Intellectual Property, he may claim additional charitable deductions based on the net income received by State University. However, Peter may not deduct the first $45,000 (his cost basis) of State University's income from the Qualified Intellectual Property. State University earns $45,000 of net income from the patent in 2016 and $150,000 in 2017 and reports those amounts on IRS Form 8899 to Peter and the IRS. During 2016, Peter can only deduct his $45,000 cost basis, because Peter's deductible amount for State University's Qualified Donee Income equals his basis. For 2017, Peter may claim an additional deduction of $150,000, which represents State University's Qualified Donee income during 2017. Peter's $45,000 charitable deduction in 2016 has the normal five-year carry forward. Peter's deduction for State University's Qualified Donee Income of $150,000 as reported for the tax year 2017 is treated as a charitable gift made during 2017 and may be carried forward for five additional years (2018 – 2022).

Importance of Fiscal Years. For donors whose fiscal year is a calendar year and who contribute Qualified Intellectual Property in January to a charity that also uses the calendar year as its fiscal year, the donor may deduct at 100% the first 23 months of Qualified Donee Income (e.g., for a Gift on January 15, 2016, Qualified Donee Income earned by the charity from January 15, 2016 through December 31, 2017). On the other hand, if the same donor makes the gift on December 15, 2016, then the donor can only "benefit" from the 100% deduction for a little over 12 months of Qualified Donee Income.

To further complicate matters, either the donor or the donee could have a fiscal year that is not the calendar year. It is not uncommon for a charity to have a fiscal year that is other than the calendar tax year. For example, many educational institutions use a fiscal year

[27] See IRC §170(m)(1).

that ends in June. For such schools, the IRS Form 8899 must be filed with the donor and the IRS by July 31. If the donor files taxes on the calendar year, then the Qualified Donee Income reported on the Form 8899 filed by the charity for July 31, 2017 is reported by the donor on his/her 2017 tax return. It is important to note that for a gift on September 15, 2016 to a charity with a June fiscal year, the donor's first tax year ends December 31, 2016. The charity will not have filed a Form 8899 yet, so the donor gets no additional deduction for 2016 even if the charity generated Qualified Donee Income during 2016. The first time the charity will file a Form 8899 is July 31, 2017, which occurs during the donor's second tax year.

V. Helping Your Donors by Applying Your CRT Knowledge.

One of the greatest skills we bring as gift planners to any gift planning conversation is the skill of listening to what the donor says and then interpreting that information into a usable plan. Even when donors describe a CRT or endowment fund, they still cannot rely on the vast knowledge base that you bring to the table. As your experience increases, your skill also increases. The better you are able to hone your skill, the better plans you will be able to create for your donors.

Now, we’ll turn our focus to applying CRT planning in donor scenarios. Each scenario will start with a basic fact pattern including the donor’s goals. Then, we’ll apply a CRT to their situation.

A. Increasing Cash Flow

Steve and Judy Clark, both 67 years of age, have been retired for two years. While they are living comfortably on their current retirement income, they are concerned about the effects of inflation on their purchasing power in the future. They would also like extra income for occasional trips and other modest luxuries they currently cannot afford. At the same time, the Clarks want to make a substantial gift to the local Boys and Girls Club that they have been involved with over the years.

The Clarks own $1 million worth of stock in the publicly-traded company where Steve worked for many years. As an employee of that company, Steve received stock options, exercised them over time and has a cost basis of only $100,000. The stock has been a very good growth stock, but produces minimal dividend income. The Clarks considered selling some of the stock and reinvesting it in an income-producing portfolio, but they didn't like the idea of “donating” part of their gains to the Internal Revenue Service in the form of capital gain taxes.

Fortunately, the Clarks’ financial planner is familiar with charitable gift planning and proposes a solution to help them achieve their objectives and eliminate capital gain tax erosion. The Clarks give half of their stock to a charitable remainder trust (CRT) for which they can claim a $105,000 income tax deduction. The CRT sells that stock for $500,000, a savings of $87,000 in capital gain taxes. The sale proceeds are reinvested to provide a variable, supplemental payment stream of approximately $40,000 before taxes.

They also sell the other half of their stock outside the CRT. Although they will owe $124,000 of capital gain taxes on this portion, their income tax deduction from funding the

CRT partially offsets this tax. More importantly, the Clarks will also retain access to the net proceeds. Since they originally wanted all of the stock to go to the local Boys and Girls Club, they amend their wills to ensure this portfolio also will benefit this charity. At the Clarks' death, the remaining assets in both the CRT and the new portfolio will be distributed to the Boys and Girls Club.

The $500,000 gift of stock to the CRT not only reduced immediate capital gain taxes the Clarks would have incurred with a complete sale, but it also created an income tax deduction that substantially improved their net cash flow. Additionally, the Clarks will create more lifetime spendable income and make a larger gift to their favorite charity.

B. Temporarily Increasing Cash Flow

Tim & Lynn Porter both 60 are planning for their golden years and expect to retire soon. They discuss with their financial advisor various elections they can make regarding their Social Security, 401(k) plan and other retirement income sources.

Tim & Linda's financial advisor informs them that for each year they delay their Social Security distributions, their Social Security benefit will be 8% higher per year compounded. Their advisor also reminds them that if their 401(k) converts to an IRA, they must start receiving a "Required Minimum Distribution" from the IRA each year once they turn 70 ½.

Tim & Lynn decide that tax-free deferral and compounding makes the most sense for them, but only if they can support their cash flow needs from now until age 70.

With their advisor's help, Tim & Lynn create a 10-year Charitable Remainder Annuity Trust (CRAT) with $500,000 of a stock they bought years ago. The CRAT is designed to cover their cash flow needs until their IRA, Social Security benefits and other retirement income sources start paying.

The $500,000 stock gift to the CRAT not only reduced approximately $72,000 of capital gain taxes that Tim & Lynn would have incurred by selling the asset, but also created a $70,000 income tax deduction that substantially improved their net cash flow. Additionally, Tim & Lynn will create a 10-year cash flow that bridges the beginning of their retirement until their traditional retirement cash flow begins. Finally, Tim and Lynn make a nice gift to the TIM & LYNN PORTER DONOR-ADVISED FUND, which makes grants to charities recommended by Tim & Lynn.

C. Stopping the §1031 Merry-Go-Round

Vicki Russell (age 64) learned at an early age that real estate investing was her passion. She bought her first investment property in her college town shortly after graduation. Her motto was "God isn't making any more real estate." Vicki learned that her strength was the fixer-upper as she bought, fixed up and sold 20 properties over the next 30 years. In the last decade, she sold most of her properties via a §1031 tax-deferred exchange. Vicki is ready to sell one of her properties ($400,000 value with no debt and $30,000 basis) but no longer wants the headache involved with a new property.

Her advisor, Jim London, suggests another tool that also provides tax-deferral. Jim explained to Vicki that a tax-exempt CRT could meet her goals. By controlling her social capital — the wealth she cannot keep that usually goes toward taxes — Vicki will reduce her capital gain tax liability, avoid estate taxes, receive an income tax deduction, receive a lifetime cash flow, and create a lasting legacy in her hometown.

Putting her new plan in place, Vicki transfers the building to a newly-created CRT which sells the building. Because the CRT is tax-exempt, the full amount of the sale proceeds is available for investment without any reduction for capital gain tax. The sales proceeds are invested to produce a cash flow consistent with the 6% CRT payout rate Vicki and Jim selected. At her death, Vicki's CRT will create a donor-advised fund in her name with the local Community Foundation that makes a permanent annual 4% distribution to charities in the town where Vicki bought most of her properties.

In addition to selling her real estate without having to pay $94,000 of immediate capital gain tax, Vicki's benefits include an immediate income tax charitable deduction of $150,000, a lifetime cash flow of $542,000, and the future funding of an endowment fund valued at $550,000. From a present value basis, her lifetime cash flow equates to $396,000 and the future endowment fund is valued at $306,000.[28]

D. Mortgaged Real Estate

Larry and Beverly McCormick, age 65 and 63, want to retire to a warmer climate that is closer to their two children. The McCormicks also want to make significant gifts to nonprofit organizations that benefit the residents of their longtime hometown; thereby creating a legacy that will last long after they leave the city.

Several years ago, the McCormicks purchased two commercial buildings on the outskirts of town for $250,000 each. These buildings have become prime real estate properties that have appreciated in value to $3 million each. Each building is currently encumbered by a $500,000 mortgage. While they own significant other assets, they want to focus their current planning on these two properties.

The McCormicks are concerned that their objectives to provide inheritances for their children and contribute to their community won't be met due to the tax liability they will incur when they sell the highly appreciated real estate.

At a meeting with their financial planner, they learn how a tax-exempt charitable remainder trust (CRT) can meet their goals. By controlling their social capital — the wealth they cannot keep that usually goes toward taxes — the McCormicks will reduce their capital gain tax liability, avoid estate taxes, receive an income tax deduction, receive a lifetime cash flow, and create a lasting legacy in their hometown.

Putting their new plan in place, the McCormicks first sell one of the buildings outright and use the net proceeds to pay off the mortgages on both properties. They then give the second building to a newly-created CRT which sells the building. Because the CRT is tax-exempt, the full amount of the sale proceeds is available for investment.

The sales proceeds are invested to produce a cash flow consistent with the 6% CRT payout rate selected by the McCormicks. Using a portion of this cash flow and the tax savings from the income tax charitable deduction, the McCormicks are able to make gifts

[28] The rate for present value calculations is 3%.

to a Wealth Replacement Trust to purchase life insurance that will benefit their children. When the CRT matures at the death of the last CRT income beneficiary, the remaining CRT assets will be paid to the hometown charities selected by the McCormicks.

Mortgaged Real Estate Creates the Following Five Problems in CRT Planning:

1. Grantor Trust

If the trust pays the donor's debt using its earned income (including realized capital gains), the trust will be treated as a grantor trust and cease to qualify as a CRT.

2. Unrelated Business Taxable Income

Debt inside a CRT can create unrelated business taxable income (UBTI). Any UBTI created inside a CRT is subject to a 100% excise tax[29]. The UBTI may be created by either income or realized capital gains from the property subject to debt.

3. Self-Dealing

If the CRT pays any portion of the donor's debt, a prohibited act of self-dealing will occur, excise taxes will be due and the trust's tax-exempt status may be threatened by self-dealing acts.

4. Bargain Sale

If encumbered real estate is contributed to a CRT, the donor must realize some capital gain as a direct result of the gift.

5. Reduced Income Tax Deduction

The existence of the mortgage reduces the equity value of the gifted real estate. As a result, the donor's income tax charitable deduction will be reduced.

It is often difficult to find a legal and practical strategy that overcomes each of these five problems. However, there are several creative solutions that, with careful planning and flexibility on the part of the donor, can generate benefits for all parties.

Possible Solutions

The following potential solutions to the five problems are listed in general order of safety and simplicity.

Pay off the debt and contribute unencumbered property.

This will avoid all five problems. However, it requires that the donor have sufficient liquid capital to retire the debt and be willing to use that liquidity to solve the problem.

[29] IRC §664(c) was amended by Section 424(a) of the Tax Relief and Health Care Act of 2006. This became effective for tax years beginning on or after January 1, 2007. Any UBTI prior to this date cancelled the tax exempt status of the CRT for the year in which it was received.

Remove the debt by offering substitute collateral to the lender. Then, give the unencumbered property.

This also solves all five problems but leaves the donor personally liable for the debt. When considering this alternative, it may be important to keep in mind that the donor was originally responsible for the debt. In addition, the CRT's design and investments may be structured to increase the donor's cash flow and ability to service the debt. Further, the lender must agree to the collateral for the new debt.

Pay off the debt. Contribute a fractional undivided interest in the unencumbered property to the CRT and sell the other portion outright. Use the proceeds of the outright sale to replace the personal capital used to pay off the debt.

Some donors have the capital to retire the debt, but are unwilling to do so because it would place them in an uncomfortable illiquid position. This third strategy requires only the temporary use of the donor's liquid assets to pay off the debt. The capital is then recovered from the sale proceeds from the portion of the property retained and sold personally by the donor. So long as the gift to the CRT is completed during the same taxable year as the outright sale, the income tax charitable deduction for creating the CRT can offset some of the capital gain generated by the outright sale of a portion of the property.

Sell an undivided interest in the property to an unrelated third-party. Use the proceeds to pay off the debt then, contribute the remaining unencumbered property to the CRT.

As with the previous technique, this sale may generate a partial taxable gain to the seller. However, the sales proceeds can be used to retire the debt and the remaining unencumbered portion can be gifted to a CRT. (Note that this has a very similar tax effect as the bargain sale considerations of giving encumbered property.) The seller will need enough proceeds from this sale to retire the debt and pay the tax on the sale itself. For techniques 3 and 4 above, the following formula provides an approximation of how much of the property to sell inside the CRT versus outside the CRT:

$$V = D / 1\text{-}C(1\text{-}B\text{-}F)$$

where: V = Property Value when sold

D = Debt

C = Donor's capital gain tax rate

B = Percentage of cost basis

F = CRT charitable deduction factor %

Ask the mortgage holder to release an undivided interest in the property. Then, contribute a fractional interest in the (now) unencumbered property.

There can be no certainty that a lender would do this. However, if the client a) has a strong relationship with the lender, b) explains why the request is being made and that the property is expected to be sold soon and c) potentially offers additional collateral, some lenders may be willing to cooperate.

E. Divorce Planning

George and Ann Brown are divorcing. He has consulted his financial advisor about the best way to structure the divorce settlement. George's net worth is $20,000,000 and he acquired the majority of these assets before his marriage. Ann suggests a $5,000,000 settlement. George wants to be fair to Ann but is concerned that if he gave her a large sum of money outright she would spend it quickly and be destitute once the money was gone.

George's financial advisor shows him a creative way to solve these problems. George can set up a Charitable Remainder Unitrust and fund it with $5,000,000 of highly appreciated publicly traded stock. George names his wife as the income beneficiary and, with the blessing of Ann's attorney, includes a provision that if she ever remarries, her income interest will terminate and the assets in the trust will be distributed to George's private foundation. George names himself as trustee. If George creates and funds this trust while still married to Ann or pursuant to the divorce settlement, this will not be a taxable gift.

Since George is funding the Charitable Remainder Trust, he will get an income tax deduction of $1,147,000. George saves $1,104,000 in capital gain tax on the sale of the stock and Ann will receive regular income payments for the rest of her life. If she lives to her life expectancy and does not remarry, the anticipated lifetime cash flow would be $12,714,000.[30] At her death, the trust assets of $9,238,000 will fund the George Brown Private Foundation, which will be run by George's heirs.

Sidebar on Qualified Contingency:

The provision in the CRT that turns off Ann's interest if she remarries is called a "Qualified Contingency". Such a provision is not required in a divorce CRT; however, this is what George required and Ann agreed to as part of the divorce negotiation process.

In 1984, IRC §664 was amended to add §664(f) to permit an income interest in a qualified CRT to terminate upon the happening of a "qualified contingency." This statutory modification was made retroactive for transfers made as early as 1978. A "qualified contingency" is any provision of a trust which provides that, upon the happening of a "contingency," the unitrust or annuity trust payments will terminate "not later than such payments would otherwise terminate under the trust." The inclusion of a qualified contingency clause has no impact on how the donor's income tax charitable deduction is computed.[31] The charitable remainder for income tax charitable deduction purposes must be determined without regard to whether the contingency could ever occur.

[30] Ann's cash flow stream will be taxed at her marginal rate.

[31] See IRC §664(f)(2).

A Qualified Contingency is most commonly implemented by describing an external event (such as death of another person, divorce or remarriage of an income beneficiary) the occurrence of which will shorten somebody's income interest in the CRT.[32]

F. IRAs at Death

Martha Cole (age 85) and her late husband Frank worked hard but lived modestly. Now Martha's assets include an IRA valued at $1 million, a personal residence valued at $500,000, and a securities portfolio valued at $2.5 million. Martha's sole heir is her thrice-married daughter Jane, currently age 65. Martha wants to provide a lifetime cash flow to Jane from the IRA, but is concerned about Jane and her 3rd husband's ability to preserve the inheritance if they have ready access to the IRA balance after Martha's death. In addition, Martha wants to reduce her taxable estate.

Martha's professional advisory team recommends that Martha consider designating a charitable remainder trust (CRT) for Jane as the beneficiary of the IRA. The CRT will include a strong spendthrift clause that restricts Jane's ability to assign her interest. By doing so, Martha will:

- Provide Jane with a steady stream of lifetime cash flow while limiting access to the IRA principal;
- Avoid IRD tax on the IRA; and
- Avoid immediate taxation if the IRA is liquidated in a lump sum.

In addition to the familial benefits Martha receives as a result of naming a CRT as the designated beneficiary of her IRA, she also is privileged to make a substantial gift to the charity of her choice.

Because Martha's estate is below the 2017 Estate Tax Exemption amount of $5,490,000, her estate will not benefit from the charitable deduction. However, Martha's main goals were to ensure that Jane will receive a lifetime cash flow from the IRA proceeds and ensure that neither Jane nor her 3rd husband can spend the entire IRA proceeds in a short timeframe.

Additional Comments:

A stretch IRA could provide the lifetime cash flow to Jane; however, most practitioners know that stretch IRAs are fully dissolved within 10 years.

G. Charity Avoids Liability for Gift of Shares of a Business

William Jackson, a successful entrepreneur, wants to make a $1.5 million gift (half of his interest in Financial Services, Inc.) to create an endowed professorship at his alma mater. The owner of a number of closely held businesses, he approaches the university about a contribution of closely-held stock in Financial Services, Inc. Although several competitors are willing to buy the $3 million company, the university's CFO, after careful consideration, rejects the gift because it is not marketable.

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[32] For another use of Qualified Contingency, see Revenue Procedure 2016-42 in which certain CRATs must terminate early if the CRAT falls below a calculated value.

William's financial advisor offers an alternative solution to this dilemma. He suggests contributing the stock to a two-year term, tax-exempt, net income charitable remainder trust (CRT) naming the university as the remainder beneficiary. This solution shifts the burden of selling the asset away from the charity and gives the CRT trustee a full two years to negotiate the sale of the business with only a modest reduction in William's income tax charitable deduction.

William receives a $1,357,000 charitable income tax deduction, which is about 90% of the value of the contributed stock. He avoids $414,000 in immediate capital gain taxes he would have paid had he sold the stock and made a cash gift of the proceeds. He removes $1.5 million from his estate reducing his estate tax burden. In addition to his tax savings, he accomplishes his goal of creating an endowed professorship at his alma mater.

Additional Comments:

This scenario provides a way that charities can receive gifts from business owners even if the university's CFO refuses to take title to a closely-held business. By inserting the CRT in the process, the donor can still give shares of his/her business to charity. The donor can be in charge of the sales negotiation. Your charity will still receive the bulk or all of the sales proceeds. By limiting the noncharitable term to two years, the donor's income tax deduction benefit is still about 90% the same as an outright gift.

This scenario could equally apply to gifts of real estate or other gifts, which the university's CFO refuses to accept as an outright gift due to liability concerns.

Another option would be to use a Donor-Advised Fund as the intermediary. Additionally, per IRS Notice 2012-52, a transfer to a single-member limited liability company (SMLLC) where a qualified charitable organization is the sole member is treated for income tax deduction purposes as though it is a charitable gift made to the charitable organization. Because the SMLLC is designed to protect the charity against any potential liability arising from direct ownership of the gift, the SMLLC should be created by the charity and not by the donor.

Therefore, some charities create SMLLCs to receive gifts of assets that carry potential liability. If operated correctly, the SMLLC shields the charity from liability associated with direct ownership of unmarketable assets such as gifts of business interests and real estate, while allowing the donor to claim a full deduction for the gift.

H. ESOPs and CRTs

Twenty-five years ago, Sam Carson started Empire Construction Company, a C-corporation. Over the years, Empire grew and became quite successful. It recently appraised for $5,000,000. At age 60, Sam wants to sell the business to a management team consisting of his children and other key employees. However, with only a $500,000 basis, Sam wants a plan that will result in a minimum amount of taxes. In addition, Sam and his wife Irene (also 60) want to devote more time and energy to a nonprofit community development initiative in which they are involved.

Sam and Irene discuss these goals with their financial advisors who suggest the following solution: Sam and Irene will contribute 60% of their Empire stock to a Charitable Remainder Trust (CRT). The CRT provides Sam and Irene with the following benefits: an immediate income tax deduction, deferral of capital gains on the sale of the Empire stock and a lifetime cash flow. Sam and Irene elect to name a donor-advised fund as the charitable remainder beneficiary to fund the community development initiative as well as their other charitable interests.

Additionally, Empire will set up an Employee Stock Ownership Plan (ESOP) structured to confer the maximum possible benefits to the management team. The ESOP will obtain a loan and purchase the Empire stock from the CRT. The CRT will invest the sales proceeds in a diversified portfolio of securities to provide lifetime income to Sam and Irene.

Sam and Irene's integrated plan helps them transfer their business to the management team with a minimum amount of taxes while providing them with a lifetime cash flow and a permanent fund to benefit charities in their community.

To put numbers to the plan, by funding the CRT with their Empire stock, Sam and Irene can claim a $649,000 income tax charitable deduction, avoid immediate capital gain tax of $745,000, fund a future expected $4,000,000 gift to charity, and expect to receive lifetime cash flow from the CRT of $6,021 ,000.

VI. Concluding Remarks

Charitable Remainder Trusts 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

CRTs can be funded with a variety of assets including stocks, bonds, mutual funds, restricted securities, exchange funds, real estate in various forms, partnership interests, limited liability companies (LLCs), C-corporations, art and other tangible property. When combined with other estate, finance and charitable planning tools, the CRT can solve many of your donor's noncharitable problems and goals within a charitable context.

Listen for the magic words donors say so you can catch the CRT opportunities. Then, match the donor's goals with your knowledge of CRT planning to help your donors make their ultimate gift.

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Appendix A: Adjusted Gross Income Limitations on Income Tax Charitable Deductions

Type of Contribution	**Publicly-Supported Charities** Including **Donor-Advised Funds** Deduct	AGI Limit	**Private Non-Operating Foundations** Deduct	AGI Limit
Cash	Cost	50%	Cost	30%
Marketable Securities	FMV	30%	FMV	20%
Other Long-Term Capital Gain Property	FMV	30%	Cost	20%
Election to Reduce Deduction	Cost	50%	N/A	N/A
Tangible Personal Property				
Use is ***Related to*** Charity's Mission	FMV	30%	Cost	20%
Use is ***Not Related to*** Charity's Mission	Cost	50%	Cost	20%
Qualified Intellectual Property	Cost	50%	Cost	20%

Tangible Personal Property includes any touchable property. Special rules apply to cars, boats and planes.

Qualified Intellectual Property includes Patents, Copyrights, Royalties and similar property. The donor's deduction is limited to the smaller of cost basis or market value. Additionally, for Qualified Intellectual Property gifts to a publicly-supported charity, the donor may request that the charity report to the donor how much net income the charity earns from the gift during the 10 years following the gift. The donor can treat this net income as additional contributions on a sliding scale based on numbers reported by the charity to the donor and IRS on Form 8899.

Long-term Capital Gain property includes capital assets such as stocks, bonds and other assets that would yield long-term capital gain, e.g., held more than one year.

An **Election to Reduce the Deduction** is the opportunity to deduct against 50% of AGI instead of 30% of AGI in return for using cost basis instead of Market Value in determining the deduction. See §170(b)(1)(C)(iii) for other restrictions.

Special rules apply for gifts to Charitable Lead Trusts, gifts of Ordinary Income property and gifts of Short-Term Capital Gain property.