



CHARITABLE REMAINDER TRUSTS

Memorandum to the Settlor and to the Trustee

by Layne T. Rushforth

1. GENERALLY

This memorandum is for the Settlor and the Trustee of an irrevocable charitable remainder trust. There is a section for each of you, but we recommend that the Settlor and the Trustee read both sections. The trust has at least one individual beneficiary and at least one charitable beneficiary¹. The trust can endure for a specified number of years or for a designated beneficiary's lifetime. It is possible to create a charitable trust where the Settlor is not the individual beneficiary, and it is possible to make payments to the noncharitable beneficiary for a fixed period of years rather than for life; however, this memo assumes that the Settlor is the sole lifetime beneficiary.² This memo also assumes that the charitable beneficiary or beneficiaries receive the trust assets upon the Settlor's (or surviving Settlor's) death. If the charitable trust continues for the benefit of any noncharitable beneficiaries (such as children), the income, gift, and estate-tax implications differ significantly from those outlined here.

2. INSTRUCTIONS TO SETTLOR

Here are a few guidelines for the Settlor to keep in mind after signing an irrevocable charitable remainder trust:

2.1 Initial Contribution: After signing the trust, make the initial contribution of assets *to the Trustee*. You must give up all of your rights to the trust assets, and all trust assets must be owned "free and clear" (i.e., without a mortgage, trust deed, or other security interest). You may be the Trustee, but if you choose to be the Trustee, you must be careful to strictly follow the terms of the trust instrument.

2.2 Additional Contributions: *If the trust is an "annuity trust", you may only contribute assets to the trust once; additional contributions to charitable remainder annuity trusts are prohibited under the Internal Revenue Code.* If the trust is a "unitrust", you may make additional contributions of assets to the trust, as you deem appropriate, but never tell the Trustee what to do with those contributions. If you have a unitrust, before you make additional contributions, consider the following:

(a) Because the unitrust payments to the life beneficiary (you) are based on the value of the trust estate, each time a contribution is made, the trust payments must be adjusted. Even the unitrust percentage may have to be adjusted, and the unitrust percentage may vary from contribution to contribution. To avoid complicated calculations, it is more efficient to

¹The Settlor may have the right to change the charitable beneficiaries, but this depends on whether or not that right was reserved by the Settlor at the time the Trust was established. The right to change beneficiaries will affect the amount of the charitable deduction.

²This memo sometimes refers to a single Settlor, but the same principles apply to a two-settlor charitable remainder trust except that references to "the death of the Settlor" should be read as references to "the death of the surviving Settlor".



make one large annual contribution than several smaller monthly ones. It is imperative that the trust payments be accurately calculated.

(b) The valuation of trust assets must be made accurately, and either an independent Trustee must determine asset values or a qualified appraiser (as defined in the Internal Revenue Code) must be engaged. A Settlor cannot determine asset values even if acting as Trustee. As a practical matter, except for gifts of cash and marketable securities, the value of contributed assets should be determined by a qualified appraiser.

(c) Contributions are reportable gifts. Although no gift tax is required because this is a charitable remainder trust, a gift tax return (IRS Form 709) is required for each calendar year in which contributions are made. Contributions to the charitable trust do not reduce your annual exclusion gifts to individuals or your applicable exclusion for gift and estate taxes³. **Recommendation:** *Have your tax accountant prepare the gift tax return (IRS Form 709) at the same time your individual tax return is done.*

(d) You have no obligation to make additional contributions to the charitable trust, but unless the trust has cash or income-producing assets, the trust may not be able to pay all of its obligations, such as property taxes and assessments, property maintenance costs, Trustee's fees, accountant's fees, attorney's fees, and appraiser's fees. As a practical matter, you may need to contribute cash to cover those expenses. **Recommendation:** *If the property you contributed to the trust is not income producing, you should seriously consider contributing enough cash to cover anticipated expenses.*

2.3 **Distributions to You:** For charitable remainder *annuity trusts*, the annual payments will remain the same, based on the value of the initial contribution. For charitable remainder *unitrusts*, the distributions to you are based on the unitrust percentage of the value of the assets, as determined for each tax year. The percentage amount payable to you annually must be at least 5%, but you cannot select a percentage that is so high the present value of the remainder interest (determined under the IRS valuation tables) is less than 10%.

2.4 **Income Tax Implications:** Charitable remainder trusts have two primary income tax effects. First, contributions to the charitable trust are partially deductible for income tax purposes. Second, the trust payments payable to the Settlor are taxable income to the Settlor.

(a) Because the charity does not have the right to receive any distribution from the trust until the death of the Settlor, your income-tax deduction is limited to the present value of the remainder interest, which is determined from the IRS valuation tables and is based on the Settlor's age, the current applicable federal interest rate, and the specified annuity or

³Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. This is sometimes called "the exemption equivalent of the Unified Credit". For ESTATE TAX purposes, the applicable exclusion has been, is, and will be: \$625,000 in 1998; \$650,000 in 1999; \$675,000 in 2000; \$1,000,000 in 2002 and 2003; \$1,500,000 in 2004 and 2005; \$2,000,000 in 2006, 2007, and 2008; \$3,500,000 in 2009; unlimited in 2010; and \$1,000,000 in 2011 and beyond. The applicable exclusion for GIFT TAX has been \$1,000,000 since 2002 and is not scheduled to change.



unitrust percentage that is used to calculate the Settlor's annual trust payments. You should not rely on any estimate of the charitable deduction that was computed prior to the creation of the trust. Instead, you should have your accountant calculate the exact charitable deduction. If cannot take the full allowable deduction for the calendar year during which the contribution was made, this deduction can be carried forward for five years.

(b) The charitable trust should not have to pay any federal income taxes, but the trust payment that is distributed to you must be reported on your individual income tax return (IRS Form 1040). The Trustee will send you an IRS Form K-1 to attach to your individual income tax return for this purpose.

(c) The charitable deduction will depend, in part, on the type of charities named in the instrument. You may reserve the right to change the charitable beneficiaries so long as the replacement beneficiaries are qualified charities, but reserving the right to change beneficiaries will lower the maximum amount of the charitable deduction unless private foundations are excluded from the permissive beneficiaries.

2.5 Prohibited Transactions. The tax laws relating to charitable trusts prohibit certain transactions. The violation of these rules can result in the loss of the tax-exempt status of the charitable remainder trust or it can disqualify the trust for the charitable deduction for gift and estate tax purposes. The rules relating to prohibited transactions are too complicated to explain in detail here, but they generally fall into two categories: self-dealing and unrelated business taxable income.

(a) *Self-Dealing.* There are complicated rules that generally apply to private foundations that also apply to charitable trusts. Stated simply, a charitable trust cannot provide you any benefits other than the unitrust or annuity payments permitted by law. You should never engage in any personal transaction with the trust without consulting us or other tax counsel; otherwise, the trust may be totally disqualified. Because of the self-dealing rules, once you contribute property to the trust, you cannot get it back, even by buying it for full fair-market value. **Recommendation:** *To avoid self-dealing, it is best if someone other than the Settlor acts as Trustee.*

(b) *Unrelated Business Taxable Income (UBTI).* Charitable trusts are not permitted to engage in business transactions that would compete with taxable businesses. A charitable trust is entitled to receive passive income, such as rents, dividends, and interest, but it cannot own or receive payments from an active trade or business. Before making a contribution to a charitable remainder trust, you must be sure that the asset does not generate UBTI.⁴ One penny of UBTI will disqualify the trust's tax-exempt status for the entire tax year.⁵

3. TRUSTEE

⁴IRC § 512(a).

⁵IRC § 664(c).



The Trustee of a charitable remainder trust should follow these instructions:

3.1 **Acting as Trustee:** All transactions you make in behalf of the trust should clearly reflect that you are acting as Trustee. You are solely responsible for trust investments. Charitable remainder trusts require that regular payments be made to the noncharitable beneficiary. The “annuity amount” or “unitrust amount” is usually expressed in terms of a percentage of the value of trust assets. For charitable remainder annuity trusts, that value is based on the value of the assets originally contributed and will not change. For charitable remainder unitrusts, that value is based on an annual valuation of assets. If there are multiple Settlor, the trust instrument may give you discretion to allocate distributions between the beneficiaries. Under federal tax law, distributions must be made at least annually, but the trust instrument may require quarterly or even monthly distributions. In all respects, you must make the distributions as directed in the trust instrument.

3.2 **Trust Contributions:** Trust assets must be titled in your name as Trustee. You are not permitted to accept property that is encumbered by a mortgage, trust deed, or other security interest. You cannot invest in any asset that the Settlor has control over. As to *unitrusts*, the payments made to the Settlor are based on the value of trust assets, and you are required to have all assets valued as of the date of the contribution and each year thereafter. If assets are contributed to a unitrust in the middle of the year, the trust payments to the Settlor need to be adjusted in accordance with federal income tax regulations. It is your duty to make sure the value of trust assets is properly determined. Since the payments to the Settlor are based on asset values, you cannot rely on the Settlor’s declaration of value. Similarly, if you are Settlor and Trustee, you cannot be the one to determine the values of the assets, which must be handled by an independent Trustee or by a qualified appraiser. **NOTE:** If the trust is a charitable remainder *annuity* trust, no contributions may be accepted after the initial contribution of assets. **Recommendation:** *A qualified appraiser should be engaged to appraise trust assets (other than cash and publicly-traded securities), and a certified public accountant should be engaged to calculate any mid-year adjustment to the unitrust payment that is required under federal income tax regulations.*

3.3 **Cash Accounts:** All cash contributions and other cash receipts should be deposited into a separate account established solely for the trust. The bank, brokerage firm, or other financial institution should be given the trust’s tax identification number when the account is opened.

3.4 **Personal Account:** Never deposit trust contributions into a personal account or make payments in behalf of the trust from a personal account. You should never make loans of trust funds, and you should not invest in speculative investments. You should not engage in any transactions that benefit the Settlor or you or any business entities that either of you is involved in.

3.5 **Records:** Keep meticulous records relating to the trust’s assets, receipts, and expenditures. The trust should never need to pay income taxes, but if investments are improperly made, there can be exceptions. Although the charitable remainder trust is exempt from federal income tax, the Trustee is required to file two returns with the IRS on or before April 15th of each year: (1) “Split-Interest Trust Information Return [IRS Form 5227]; and (2) “U.S. Information Return, Trust Accumulation of Charitable Amounts” [IRS Form 1041-A]. **Recommendation:** *Consult with your*



certified public accountant regularly for advice on what records to keep and which investments should be avoided and to see that the required returns are properly prepared and filed.

3.6 Estate Taxes: The assets in this trust must be reported on each Settlor's estate tax return (IRS Form 706), but the trust is designed to qualify for the charitable deduction. Upon the Settlor's (or surviving Settlor's) death, you must make sure that each charity is a qualified charitable organization for federal tax purposes. The trust prohibits distributions to nonqualified organizations. If the trust is a two-settlor trust established by a married couple, the value of the survivor's benefits qualifies for the marital deduction and the value of the remainder benefits qualifies for the charitable deduction. In any event, there should be no estate tax to pay with respect to the assets in the charitable trust even though they must be included on the estate tax return.

3.7 Prohibited Transactions. As was discussed above in paragraph 2.5 of the Settlor's section of this memo, the tax laws relating to charitable trusts prohibit certain transactions.

(a) 503(b). Section 503(b) of the Internal Revenue Code specifically prohibits any exempt organization (including trusts) from giving the Settlor of a trust or a member of the Settlor's family any special privileges. For example, the Settlor, any member of the Settlor's family, and any entity controlled by a Settlor may not: borrow money without adequate security and a reasonable rate of interest; receive excessive compensation; use trust assets without fair compensation; or purchase assets for less than fair consideration.

(b) Self-Dealing. Some of the rules applicable to private foundations also apply to charitable trusts. You are responsible to see that the charitable trust provides no benefits to the Settlor, other than the unitrust or annuity payments permitted by law. You should never engage in any personal transaction with the Settlor without consulting us or other tax counsel; otherwise, the trust may be totally disqualified. Section 4941(d) of the Internal Revenue Code prohibits certain transactions with "disqualified persons".

(1) The prohibited transactions include sales, exchanges, and leases (even if full consideration is paid); loans from the trust (even with interest; loans to the trust unless without interest or other charge; payment of excessive compensation or reimbursement of expenses; transfer of property subject to a mortgage or lien that is assumed by the trust (unless the mortgage or lien is over 10 years old);

(2) "Disqualified persons" include the trustor and any other "substantial contributor", a member of the substantial contributor's family or a 20% shareholder of an entity that is a substantial contributor, and others.

(c) Unrelated Business Taxable Income (UBTI). Charitable trusts are not permitted to engage in business transactions that would compete with taxable businesses. You must reject any contribution of assets that would generate income other than passive income, such



as rents from real property, dividends, and interest. One penny of UBTI⁶ will disqualify the trust's tax-exempt status for the entire tax year.⁷

(1) Some examples of UBTI include: any income from an operating business; the UBTI income of a controlled entity (such as a partnership) to the extent it exceeds income that is not UBTI; rental income that is more than 50% derived from the rent of personal property; and rental income based on the lessee's income or profits (other than a fixed percentage of receipts or sales).

(2) *Recommendation: Instruct each broker who buys and sells securities for the trust not to invest in ANY limited partnerships, whether publicly traded or not.*

4. CONCLUSION.

While a charitable remainder trust will provide certain benefits to the Settlor, the trust is afforded special privileges and benefits because of the ultimate purpose of providing benefits to one or more qualified charities. Care must be taken by both the Settlor and the Trustee to make sure that the trust is at all times compliant with the requirements of the Internal Revenue Code and related Regulations. Failure to do so can result in the loss of the anticipated tax benefits.

[END: Version of March 22, 2008]

The Rushforth Firm, Ltd.

A Nevada Professional Limited-Liability Company

Receptionist: 702.255.4552 or 866.740.9195

Fax: 702.255.4677 or 866.740.9197

E-mail: office@rushforth.net

rushforth.net | rushforthfirm.com

9505 Hillwood Drive, Suite 100

Las Vegas, Nevada 89134-0514

⁶IRC § 512(a).

⁷IRC § 664(c).