CHARITABLE REMAINDER TRUSTS

A Charitable Remainder Trust is an estate planning technique which enables a person to (i) obtain an immediate income tax deduction, (ii) retain annual payments for life (or for the lives of others or a fixed term), (iii) avoid a tax on the sale of capital assets (e.g. stock or real property) and (iv) reduce one's taxable estate.

A. Typical Transaction

The Grantor transfers real or personal property into an irrevocable tax exempt trust and reserves for his or her lifetime or the lifetime of others (or for a fixed period of up to 20 years) annual payments based upon a selected percentage of the fair market value of the trust property. The trust property is then sold and, because no tax is paid on the sale, the Grantors receive an annual payment based on the full value of the property. Upon the death of the last surviving individual beneficiary, the property is distributed to one or more qualified charities, named by the Grantor.

B. Purpose

The motivations for using a Charitable Remainder Trust (CRT) are generally one or more of the following:

1. To avoid paying tax on the sale of appreciated assets

   a. When one sells a business or other valuable asset.

   b. When one wants to diversify investments without incurring an income tax.

2. To create a charitable income tax deduction

   a. When one has other significant taxable income.

   b. When one is to receive a large distribution from a pension plan.

3. To provide a secure annuity for the Grantor's spouse and/or children

4. To provide retirement income -- particularly with the option described below at paragraph E., entitled "Additional Benefit"

   a. When a qualified plan will not accumulate sufficient funds for retirement.

   b. When one wants to avoid certain requirements of qualified plans.

5. To defer income taxes and reduce estate taxes on certain distributions from Qualified Employee Benefit Plans and Individual Retirement Accounts

6. To achieve creditor protection for the trust principal

7. To benefit a certain charity or charities, or a family foundation

C. Selected General Provisions

1. Unitrust of Annuity Trust

Distributions to the individual beneficiary must be in the form of either a Unitrust payment or an Annuity payment.

a. Charitable Remainder Annuity Trust (CRAT) payments are fixed at the beginning based upon the initial fair market value of the property transferred to the trust; and the amount does not change. No additional contributions may be made to a CRAT.

b. Charitable Remainder Unitrust (CRUT) payments are set as a fixed percentage of the value of the trust assets as revalued each year; therefore, the payments change as the value of the trust assets changes. Additional contributions may be made to a CRUT.

(1) A Unitrust may provide that the individual beneficiary will receive annual payments equal to the lesser of the net income of the trust or the stated percentage (Net Income Trust).

(2) The "Net Income Trust" CRUT can include an optional "make-up" provision so that if the income for any year exceeds the stated percentage amount for that year, the excess will be paid to make-up for any shortfalls in prior years ("Net Income Trust Make-Up Trust).

(3) The trust may provide for a "Net Income" payment for an initial period and then "flip" to a straight percentage payment for the remainder of the term. The "flip" may be triggered by a specified date or by a single event, the occurrence of which is not discretionary with, or within the control of, the Trustees or any other persons (e.g. the sale of unmarketable assets, marriage, divorce, death or birth of a child).

2. Trustee

The Grantor may act as Trustee of the CRT.

a. Certain discretionary powers may not be retained.

b. A qualified independent appraisal must be obtained for unmarketable assets.

3. Charitable Remainder

a. The Grantor may designate multiple and alternate charitable remainder beneficiaries.

b. The Grantor may retain the right to remove, change, and add charitable remainder beneficiaries.

c. The charitable remainder may be accelerated.

D. Tax Consequences

1. Income Tax Consequences

a. Income Tax Deduction. The Grantor receives an income tax deduction measured by the fair market value of the property transferred to the trust, reduced by the value of the payments retained by the Grantor and any other income beneficiaries.

(1) the longer the life expectancy of the income beneficiaries the smaller the deduction.

(2) the lower the specified rate of return the larger the deduction.

(3) certain limitations exist regarding the amount of the charitable deduction that can be taken in any one year.

b. Income Taxation of Recipients. The Grantor, or any other beneficiary receiving payments, is taxed on distributions from the trust in a prescribed manner. Generally, the payments are characterized for income tax purposes in the same manner as the income earned by the trust with certain look-back provisions.

c. Income Taxation of CRT. The CRT is generally exempt from all income taxes. However, as with a qualified retirement plan, the trust is taxed on business taxable income.

2. Gift Tax Consequences

Generally, there are no gift tax consequences from establishing a CRT. However, if the trust provides for payments to someone other than the Grantor or the Grantor's spouse, (e.g. children), there may be a gift to the extent of the payment made. In that event, it is probable that no gift tax would be paid but the Grantor would use a portion of his or her unified gift and estate tax credit.

3. Estate Tax Consequences

Upon the death of the Grantor, there generally will be no estate tax on any part of the value of the CRT. However, if someone other than the Grantor or the Grantor's spouse is entitled to payments that continue beyond the Grantor's death, an estate tax would be payable, measured by the value of the individual continuing interest.

E. Additional Benefit

The Grantor can obtain a significant additional benefit from a CRUT by specially designing the trust and directing its investment strategy to produce a limited return during the early years of the trust and providing a significantly increased return in the later years. (See illustrations at paragraphs I. and J. below.)

1. The trust must be a " Net Income Make-Up Trust" i.e CRUT providing for payment of the lesser of the net income or specified percentage and must provide for a "make-up" (as discussed in Paragraph C.1.b(2)).

2. "Net Income" under the trust should be defined as including proceeds from the sale of trust assets attributable to post-contribution appreciation. Gains attributable to pre-contribution appreciation must be allocated to principle.

3. The trust must invest in assets which produce a negligible amount of trust accounting income.

   a. Investment in growth assets, not producing current income.

   b. Investment in a commercial annuity.

   c. Use of partnership for investment purposes.

   Utilizing the inherent benefits of the CRUT with the additional benefit described above will allow a Grantor to create a substantial retirement income through the use of annual contributions to a CRUT.

F. Limitations

1. The value of the charity's remainder interest in a CRT must equal at least 10% of the value of the property contributed to the trust (upon the initial contribution or subsequent contributions).

2. The annual amount payable to the grantor trust must not exceed 50% of the value of the trust assets.

G. Testamentary CRT

A Testamentary CRT (as opposed to one established during lifetime) can be established in one's estate planning documents. The purposes for a Testamentary CRT include the following:

1. Desire to benefit charity only after individual beneficiaries have been provided for.

2. Reduce estate taxes for non-spouse beneficiaries.

3. Provide for assets which are income taxable to a beneficiary upon receipt (income in respect of a decedent).

H. Major Disadvantage and Solution

For a Grantor who is not philanthropically motivated, the major disadvantage of establishing a CRT is the transfer of the trust principle to charity in the event of the early death of the Grantor (or other beneficiaries), i.e. before the Grantor has had sufficient time to realize the tax benefits of the CRT, other than the initial charitable deduction. The typical solution involves the purchase of life insurance to replace the family wealth which may be lost in the event of all early death.

I. Illustration re Sale of Property

A Grantor, age 55, in anticipation of a sale, transfers $500,000 of property (e.g. a portion of stock of his business or unencumbered real property) to a CRUT reserving for his lifetime an annual return equal to 8% of the value of the trust property. Thereafter, the property is sold; and no tax is paid on the sale. The result would be as follows:

1. The Grantor would receive an immediate income tax deduction of approximately $100,000.

2. The Grantor would receive an annual payment of $40,000, i.e. 8% of $500,000 (as compared to the return on approximately $350,000 if $150,000 in taxes were paid on the sale, assuming a nominal basis in the property transferred).

3. If the Grantor wants to reduce the amount of his return in the first few years of the trust in order to increase the return at a later date, the trust can be designed to accommodate his wishes. For example, if the trust invests in growth assets which produce a 2% current return, only 2% would be paid to the grantor. The 6% difference between the originally specified 8% return and the actual 2% return could be made up and paid to the Grantor at a later date when the trust sells its assets and/or changes its investment strategy. Furthermore, since the 8% specified rate is based upon an annual valuation of the trust assets, if growth occurs in the value of the trust assets the amount payable to the Grantor would increase.

4. The Grantor could provide that the payment continue for the benefit of his or her children or during a fixed period (not to exceed 20 years) although that would reduce the amount of the charitable income tax deduction and would cause some estate tax to be payable on the Grantor's death. Caution must be taken not to exceed the 10% limitation described in Paragraph F.1. above.

J. Illustration re Retirement Income

A Grantor, age 43, in order to provide a substantial retirement income, transfers $25,000 per year to a CRUT reserving for his lifetime an annual income equal to 7.5% of the value of the trust property; provided that in any year in which the current income earned by the trust is less than 7.5%, such lesser amount shall be paid to the Grantor and the difference between the amount actually paid and the 7.5% will be paid at a later date. Thereafter, the trust property is invested in an investment vehicle which will produce a low current return and capital growth. After contributions of $25,000 per year for approximately 24 years, the Grantor could receive a retirement income of approximately $100,000 per year. Of course, the figures would vary depending upon the assumptions used and the actual investment return obtained.

K. Creating a "Super IRA"

It is possible to design a CRUT so that the income from the assets contributed to the CRUT builds up tax free inside the CRUT and is not distributed to the donor until the donor desires the income. The ability to defer the income is achieved by placing the asset to be contributed inside a family limited partnership and contributing limited partnership interests to the CRUT instead of the underlying asset. The CRUT is not required to make annual payments to the donor until the CRUT actually receives its share of the partnership profits. Therefore, until such profits are paid, the taxable income attributable to the CRUT's earnings are "trapped" inside the CRUT and therefore not taxed since the CRUT is a tax exempt entity. Eventually, in a year that the donor needs the money, the partnership will distribute the CRUT's share of the accumulated earnings to the CRUT which will then pay out such earnings (to the extent of the accumulated unpaid annuity payments) to the donor. Such payments will be taxable to the donor in the year he receives such payments.