

THE Good Advisor

Considerations in Choosing the Trustee of a Charitable Remainder Trust

Charitable remainder trusts (CRTs) are an integral part of the planned giving landscape. Many donors and advisors are familiar with the advantages CRTs offer. However, the decision to create a CRT and the efforts made to design its features to fit a particular donor's situation can be undermined if the trustee selected is not a proper fit. The trustee needs to understand the unique tax rules for CRTs as well as the laws governing the trustee's conduct. Let's take a closer look at what is important in choosing the trustee of a charitable remainder trust.

CHARITABLE REMAINDER TRUST BASICS

To appreciate what a trustee needs to know in order to properly administer a charitable remainder trust, a short technical review of the CRT is useful.

A CRT is a split interest trust that pays out income to one or more non-charitable beneficiaries for life (or lives) or a term of years not to exceed twenty [Reg. Sec. 1.664-1(a)(1)(i)]. The selected payout rate may not be less than 5%, and no more than 50% of the fair market value of the assets originally placed in the trust [IRC Sec. 664(d)(1)(A)]. At the end of the trust term, what remains in the trust (the remainder interest) is distributed to a charity or charities selected by the donor; the actuarial value of the charity's remainder interest must be at least 10% at the time of the trust's creation [IRC Sec. 664(d)(1)(D) and 664(d)(2)(D) – for charitable remainder annuity trusts and unitrusts, respectively].

TYPES OF CRTS

Charitable remainder trusts take one of two forms: a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT).

- A CRAT pays an annuity to the income beneficiary as a selected payout rate that is a percentage of the assets valued at the time of the trust creation [IRC Sec. 664(d)(1)].

- A CRUT pays a percentage of the annual value of the trust assets, a unitrust amount, to the income beneficiary. Additional contributions to the trust are permitted [IRC Sec. 664(d)(2)].

There are variations of the CRUT that are permitted under the Internal Revenue Code:

- A Net-Income CRUT (NICRUT) permits the trustee to distribute an annual payment that is the lesser of the specified percentage of value in that year, or the net income actually earned by the trust in that year [IRC Sec. 664(d)(3)(A)].
- A NIMCRUT is a CRUT with a net-income limitation subject to a make-up provision. Like a NICRUT, the terms of a NIMCRUT direct the Trustee to pay out the lesser of the specified percentage of value of the trust assets in that year or the net income actually earned by the trust in that year [IRC Sec. 664(D)(3)(B)]. However, if less than the specified percentage is paid out in one or more years, the accumulated "income deficits" will be made up in a subsequent year in which income exceeds percentage of value of the trust assets in that year.
- A Flip CRUT permits the trust to begin its existence as a NICRUT or NIMCRUT, then "flip" into a standard CRUT upon the occurrence of a specific triggering event as described in the trust document [Reg. Sec. 1.6643(a)(1)(i)(c)-(f)].

WHO CAN BE A TRUSTEE?

Here are general observations about who can act as trustee for a CRT:

The Donor or an Individual

As a general rule, the donor is permitted to be the trustee or reserve the right to replace the trustee [Rev. Rul. 80-83, 1980-1 C.B. 210; see also Rev. Rul. 77-285,

1977-2 C.B. 213]. In general, if the donor or another individual such as a family member or friend will stand as trustee, a professional with specialized expertise in CRTs should also be retained to advise this person or to act as a co-trustee.

If the donor wants to perform the trustee function and be paid for it, an exception to the self-dealing rules permits reasonable compensation to be paid to the “disqualified person” for “personal services” [IRC Sec. 4941(d)(2)(E)]. Steps should be taken to establish the “reasonableness” of trustee fees.

A Charity

A charity may offer to serve as the trustee and perform the trustee services at little or no cost. Note that some charities may not serve as trustee because of concerns about liability or lack of internal resources. Also, a charity may not serve as trustee if it is only one of several charities that benefit from the trust, or if its remainder interest is revocable (a donor could decide to retain the power to substitute a charitable remainderman). Contact the charity to learn whether it will serve as trustee.

An Institution

An entity such as a bank or trust company can serve as the trustee. In choosing an institutional trustee, one should compare fees, investment policies and history, etc. An institutional trustee may be better qualified to manage certain assets, such as real estate, but may charge additional fees depending on the trust’s assets (per its expertise).

Dividing Trustee Responsibilities

As noted above, there can be two trustees that share trustee responsibilities. This might be advisable or even necessary for certain CRTs when funded with assets that are difficult to value.

OVERVIEW OF THE TRUSTEE’S ROLE

In establishing the CRT, the donor decides on key provisions, including naming the trustee and defining who is permitted to be trustee. The trustee makes the decisions governing the trust’s operations once it is funded. The trustee’s functions include (but are not limited to):

- Establishing the value of trust assets
- Investing of trust assets
- Measuring fiduciary accounting income
- Allocating capital gains
- Making distributions to non-charitable beneficiaries
- Filing tax returns

One important aspect of the trustee’s often difficult job is balancing fiduciary responsibilities to both the income beneficiary (usually the family) and the remainder beneficiary (the charity).

ESTABLISHING THE VALUE OF TRUST ASSETS

One of the trustee’s initial responsibilities is to value the assets contributed to the CRT. Such valuation is important first and foremost because the value of the trust assets determines the payout to the non-charitable beneficiaries and the value of the income tax deduction based on the present interest of what the charity is expected to receive.

If the trust is funded with or acquires unmarketable assets and is required to value such assets, the trustee must adhere to the rules governing current qualified appraisals and appraisers (as defined under Reg. Sec. 1.170A-13(c)(3) and (5) respectively) unless the trustee is considered an independent trustee (a person who is not the grantor, nor a non-charitable beneficiary, nor a related or subordinate party to the grantor, the grantor’s spouse, or non-charitable beneficiary) [Reg. Sec. 1.664-1(a)(7)].

INVESTING TRUST ASSETS

In the exercise of the trustee’s discretion with respect to investments, the trustee owes a fiduciary duty to the charitable remainderman, as well as the income beneficiary (which is usually the donor or a family member). The trustee’s success in investing the CRT’s assets may be met with diffidence by the income beneficiary of a CRAT, who generally is less concerned about investments unless the CRAT is so depleted it cannot even pay its annuity obligation. However, the income beneficiary of a CRUT, whose annual payment varies with the annual valuation, and the charity are vitally concerned with the CRT’s overall investment success.

FINDING A BALANCE

Balancing the interests of the parties can raise difficult issues for the trustee. The tax regulations provide that “A trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets” [Reg. Sec. 1.664-1(a)(3)].

So, the donor cannot indirectly control investments via the trust document or mandate that donated assets are to be retained rather than sold. In a private letter ruling, the IRS concluded that a CRT is not qualified if the trust document goes too far in delegating investment

responsibility to an investment advisor, absolving the trustee of investment responsibility [Ltr. Rul. 8041100]. On the other hand, state law may stress the importance of the trustee's seeking of competent investment counsel. In general, state law will often impose a "prudent investor" standard in formulating and monitoring the CRT's investment strategy [see the Uniform Prudent Investor Act].

MEASURING FIDUCIARY ACCOUNTING INCOME

A CRUT (but not a CRAT) is permitted to have an income limitation: the trustee must pay out net income if that is less than the unitrust amount. The basic nature of the income limitation is that it is a limitation which can hurt the income beneficiary and ultimately shift more assets to the charity, a contingency which does not increase the income tax charitable deduction. If the trust contains a make-up provision, the limitation may be mitigated by the presence of significant accounting income in a later year that "turns around" the prior limitations. So it is possible that the trustee's discretion in measuring fiduciary accounting income will affect the timing or the amount of payments to the unitrust's income beneficiary (or both).

The trustee may have limited discretion in measuring the trust's fiduciary accounting income, making judgments within the parameters of state law and the terms of the trust. The fiduciary accounting income concept can affect payouts and thus have tax consequences, although it is not a tax law concept per se. Also, it is not the same as measuring accounting income under generally accepted accounting principles.

ALLOCATION OF CAPITAL GAINS

IRS regulations provide: "Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized..." [Reg. Sec. 1.664-3(a)(1)(i)(b)(3)]. An issue that may significantly affect fiduciary accounting income, an issue that has a complex history, is the allocation of capital gains between principal and income. IRS regulations provide that "Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution" [Reg. Sec. 1.664-3(a)(1)(i)(b)(4)].

Proposed regulations provide that post-contribution appreciation, and even appreciation after an asset is purchased, cannot be defined as "income" pursuant to discretionary power granted to the trustee [Reg. Sec. 1.664-3(a)(1)(i)(b)(3)].

To avoid an income limitation and still treat the charity fairly, it may be necessary to allocate some capital gains (usually from equity investments) to fiduciary accounting income. This presumes that in order to treat the remainder beneficiary (the charity) fairly, the trustee is required by the fiduciary standards of the state (barring an exception) to invest in equities. Modern investment theory dictates that long-term rates of return are not maximized without some equity (more risky) investments. Also, in a very low interest rate environment, it may not be possible to avoid the income limitation even if the trust is wholly invested in relatively low-risk debt instruments.

MAKING DISTRIBUTIONS TO NON-CHARITABLE BENEFICIARIES

The tax rules provide that income flows out of the tax-exempt trust to the income beneficiary in the following order: ordinary income, capital gains, exempt income, then return of capital – also known as the four-tier accounting for CRT payments.

The trustee will also need to monitor the trust's cash flow requirements. A CRAT must distribute the annuity no less often than annually, and the CRUT must distribute the unitrust amount at least annually unless an income limitation applies. If the income limitation is subject to a make-up provision, the NIMCRUT may be required to make an unusually large distribution in a year in which there is significant accounting income.

FILING TAX RETURNS

One of the trustee's responsibilities will be filing necessary tax returns relating to the trust. The trust typically files at least two federal forms with the IRS (Forms 5227 and 1041-A) and often files a form(s) with the state as well. Usually, such forms are merely to report income that flows through to the beneficiary's return. The beneficiaries are notified of the amount and character of flow-through items. The details are often delegated to a CPA or professional administrator, but the trustee is the one responsible for the trust's tax reporting.

IN CLOSING

This is only a brief overview of the complexities of administrating and preserving a charitable remainder trust. Clients considering forming a CRT should be aware that selecting a competent trustee can be as crucial as choosing the percentage of the trust payout. We hope this review helps you in assisting your clients.

New Tax Developments

IRS Approves Reformation to Qualify Charitable Remainder Annuity Trusts

During his lifetime, an individual created a revocable living trust. Upon his death, according to the terms of the trust, the assets were divided to form two trusts. Both trusts made annuity payments equal to a percentage of the initial value of the trust assets to non-charitable beneficiaries. At the death of the non-charitable beneficiaries, the remaining assets would be distributed to a qualified charity. As drafted, these trusts would function like charitable remainder annuity trusts, but they lacked certain provisions required by Reg. Sec. 1.664-1 and 1.664-2 and so did not qualify for an estate tax deduction for charitable transfers. The trustees petitioned in Court to reform the trust documents under state law so that the trusts would qualify as charitable remainder annuity trusts. The Court required the trustees to seek a private letter ruling as a condition to issuing its order.

The IRS applied the statutory requirements for a "qualified reformation" for a trust under IRC Sec. 2055(e)(3)(B). Namely, the trusts as originally drafted provided for charitable remainder interests that were presently ascertainable and severable from the non-charitable interests. And, the trustees sought reformation within the statutory time limit. Therefore, the IRS issued a private letter ruling approving the reformation of the trusts effective on the date of death and qualifying the trusts as charitable remainder annuity trusts.

PLR 200927013

Tax Court Determines the Value of Conservation Easement

A recent Tax Court decision concerned the proper valuation for an easement as a qualified conservation contribution under IRC Sec. 170(a).

In determining the fair market value of the property, the Court took into account not only the current use of the property, but also its highest and best use (in this case, as a golf club). Usually, the historical sales data will help determine the fair market value of a donated easement, but, for lack thereof, the fair market value of an easement is equal to the difference between the fair market value of the encumbered property before the donation and its value after the donation.

Having established the criteria, the Court examined the economic value of the real property – the number of lots available for sale, the average lot price and the absorption rate (rate at which the lots sold) – before the contribution. Then the Court stated its preference for the donor's expert's reliance on comparable golf courses to determine the fair market value of the property after the contribution.

Kiva Dunes Conservation LLC et al. v. Commissioner, T.C. Memo. 2009-145, No. 13196-06

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F O U N D A T I O N

The Key Role of the Trustee of a Charitable Remainder Trust

In this issue:

The Importance of a Trustee

Who Can Be a Trustee

Establishing the Value of Trust Assets

Investing Trust Assets

Avoiding Unrelated Business Income

Measuring Fiduciary Accounting Income

Allocating Capital Gains

Making Distributions to Non-Charitable Beneficiaries

I. Introduction: The Importance of a Trustee

Since Congress passed the Tax Reform Act of 1969, the charitable remainder trust (CRT) has been an especially useful tool for achieving charitable and personal financial goals.

Though it must meet strict requirements to qualify, a CRT can be drafted to meet a variety of retirement, estate and charitable planning needs. Many donors are attracted to the flexibility in funding the trust and selecting its payout.

However, CRTs can be extremely complex and difficult to administer. Even if the trust document is well written, mistakes made during the operation of the trust can have serious consequences and lead to disqualification (that leads to the attendant loss of the charitable deduction and other tax advantages).

In this booklet, we will take a look at the key role the trustee serves in administering a charitable remainder trust.

II. Short Review of Charitable Remainder Trusts

A CRT is a split interest trust that pays out income to one or more non-charitable beneficiaries for life (or lives) or a term of years not to exceed twenty. Reg. Sec. 1.664-1(a)(1)(i). The selected payout rate may not be less than 5%, and no more than 50% of the fair market value of the assets originally placed in the trust. IRC Sec. 664(d)(1)(A). At the end of the trust term, the remaining trust assets (the remainder interest) is distributed to a charity or charities selected by the donor; the actuarial value of the charity's remainder interest must be at least 10% at the time of the trust's creation. IRC Sec. 664(d)(1)(D) and IRC Sec. 664(d)(2)(D).

Charitable remainder trusts take one of two forms: a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT).

- A CRAT pays an annuity to the income beneficiary at a selected payout rate that is a percentage of the assets valued at the time of the trust creation. No additional contributions to the trust are permitted. IRC Sec. 664(d)(1).
- A CRUT pays a percentage of the annual value of the trust assets, a unitrust amount, to the income beneficiary. Additional contributions to the trust are permitted. IRC Sec. 664(d)(2).

There are variations of the CRUT that are permitted under the Internal Revenue Code:

- A Net-Income CRUT (NICRUT) permits the trustee to distribute an annual payment that is the lesser of the specified percentage of value in that year, or the net income actually earned by the trust in that year. IRC Sec. 664(d)(3)(A).
- A NIMCRUT is a CRUT with a net-income limitation subject to a make-up provision. Like a NICRUT, the terms of a NIMCRUT direct the Trustee to pay the lesser

of the specified percentage of the value of the trust assets in that year or the net income actually earned by the trust in that year. IRC Sec. 664 (d)(3)(B). However, if the payout is less than the specified percentage is paid out in one or more years, the accumulated "income deficits" will be made up in a subsequent year from the excess income above what is the specified percentage of the value of the trust assets in that year.

- A Flip CRUT permits the trust to begin its existence as a NICRUT or NIMCRUT, then "flip" into a standard CRUT upon the occurrence of a specific triggering event as described in the trust document. Reg. Sec. 1.6643(a)(1)(i)(c)-(f). The flip option is particularly attractive when the donor wishes to donate to the CRUT illiquid or hard-to-market assets such as real estate or closely held stock. If the real estate or stock is not sold right away, or does not earn any income inside the trust, the net-income limitation relieves the trust from the obligation of paying the unitrust amount to the income beneficiary (often the donor) via distributions in kind or of partial interest. This could be a problem because a lack of cash to pay the income tax could force the sale of trust assets.

III. General Overview

The trust instrument itself is the primary source of the trustee's powers and duties. The terms of the trust can expand or limit the powers afforded to the trustee under state statutes – though only to the point where such powers and duties are not contrary to state law. One key factor that must be understood by the trustee is the applicability of state law as stated in the terms of the trust (i.e., what state is named as the domicile of the trust). And one key area of state law the trustee should know is the duties outlined in both versions of the Uniform Prudent Investor Act and Uniform Principal and Income Act enacted in that state.

In addition to the duties of the trustee outlined in the trust document and applicable by state law, there are a series of additional duties as established through common law and refined by precedent. These include:

- Duty of Loyalty;
- Duty to Deal Impartially with Beneficiaries;
- Duty to Exercise Reasonable Care and Skill;
- Duty to Keep and Render Accounts;
- Duty to Keep Trust Property Separate.

In establishing a CRT, the donor decides on key provisions, including naming the trustee and defining who is permitted to be trustee. The trustee makes the decisions governing the trust's operations once it is funded. The trustee's functions include (but are not limited to):

- Establishing the Value of Trust Assets;
- Investing of Trust Assets;

- Measuring Fiduciary Accounting Income;
- Allocating Capital Gains;
- Making Distributions to Non-Charitable Beneficiaries;
- Performing Other Administrative Functions.

IV. Who Can Be a Trustee?

Individual as Trustee

As a general rule, the donor is permitted to be the trustee or co-trustee, or reserve the right to replace the trustee. Rev. Rul. 80-83, 1980-1 C.B. 210, which preceded Reg. Sec. 1.664-1(a)(7) regarding valuation of unmarketable assets; Rev. Rul. 77-285, 1977-2 C.B. 213. However, a qualified administrator or tax professional with specialized expertise in CRTs should probably be retained if the donor or other family member is to be trustee. This is especially true since the advent of the Uniform Prudent Investor and the Uniform Principal and Income Acts requires more diligence by the trustee in the way of investment and distribution functions.

It is possible that an individual (including the donor) wants to be paid for serving as the trustee. An exception to the self-dealing rules permits reasonable compensation to be paid to a disqualified person for personal services. IRC Sec. 4941(d)(2)(E) and Reg. Sec. 53.4941(e)-1(c)(6). A definition of a disqualified person under IRC Sec. 4946(a) often includes the family members most likely to be singled out as trustee. However, it is important to take steps to establish the “reasonableness” of trustee fees (e.g., proof of hours worked, expertise, ability and training, and prevailing economic conditions).

The trustee can be an income beneficiary of the CRT (the donor or someone else). Furthermore, the donor can also reserve the right to replace the trustee with another person or entity, including himself. Note that grantor trust rules apply to CRTs so those powers outlined in IRC Sec. 671-677 may disqualify the trust if retained by the donor as trustee.

Charity as Trustee

A charity can serve as a trustee. Oftentimes, a charity will perform this function for a low fee or no fee – which can be a factor in favor of the beneficiaries. However, some charities do not choose to serve as trustee because of concerns about liability or lack of internal resources. Furthermore, a charity is unlikely to serve if it is only one of many charities who benefit from the trust, or if its remainder interest is revocable by the donor.

Institution as Trustee

An institution such as a bank or trust company can serve as a trustee. In choosing an institutional trustee, one would compare fees, investment policies and historical returns, etc. An institutional trustee may generally be better qualified to manage certain assets, such as real estate. Also, an institution may

be a good choice if continuity is an issue – a bank is more likely to be “alive”, willing and able to serve as trustee in twenty or thirty years, as opposed to a specific individual (this is an especially apt consideration for a testamentary CRT when trust inception could be many years into the future).

Successor Trustee

The issues involved in selecting a trustee also pertain to successor trustees. Note that one additional function a successor trustee must conduct is the examination of those actions made by the preceding trustee.

Dividing Trustee Responsibilities

A co-trustee or special trustee might have only certain responsibilities.

If the trust is funded with or acquires unmarketable assets and is required to value such assets, the trustee must either utilize a current qualified appraisal as defined in Reg. Sec. 1.170A-13(c)(3) from a qualified appraiser as defined in Reg. Sec. 1.170A-13(c)(5) or an independent trustee must value such assets per Reg. Sec. 1.664-1(a)(7)(i).

An issue with the potential to undermine a CRT is the “anticipatory assignment of income” which can occur when there were negotiations prior to the donation of assets to the CRT. The anticipatory assignment of income is a problem when a taxpayer hopes to avoid tax liability by transferring appreciated property to another party. If the circumstances fairly raise the issue of whether the gain belongs to the trust or the donor, an independent trustee (or special trustee assigned to sell the donated assets) may help because an independent trustee can confirm that he or she was the one who decided to sell on behalf of the trust. *Palmer v. Comm’r*, 62 T.C. 684, acq. in Rev. Rul. 78-197, 1978-1 C.B. 83; *Rauenhorst v. Comm’r*, 119 T.C. No. 9 (2002); Rev. Rul. 60-370, 1960-2 C.B. 203.

V. Establishing the Value of Trust Assets

A difficult issue that can arise at the time of trust inception is determining the tax basis of the trust’s assets. Typically, the donor has a low cost basis in the donated assets, and such basis carries over to the trust. For example, if the donor funds the trust with listed securities costing \$100,000 and having a value of \$500,000, the relevant information for establishing the basis is when the donor acquired the securities and how the \$100,000 is allocated among the securities in the trust. But consider a more complicated scenario: say the donor retained the income interest and named one successor beneficiary upon his or her death. Trust assets are brought into the donor’s estate because of the retained income interest which triggers a step-up (or step-down) in basis to the extent these assets are included in the estate. The result is that the trust is also entitled (or required) to restate tax basis. PLR 200202078.

Before accepting trustee responsibilities, it is sometimes recommended that the trustee secure in writing from the donor a confirmation of the responsibility to provide the trustee support for basis, holding period and classification for the assets that fund the trust. In the case of CRUTs (which permit the contribution of additional assets after the initial funding), the responsibility extends to the later contributions. For testamentary CRTs, the trustee may ask the executor to provide the basis information and valuations as required.

VI. Investing of Trust Assets

In the exercise of the trustee's discretion with respect to investments, the trustee will owe a fiduciary duty to the charitable remainderman, as well as the income beneficiary (which is usually the donor or a family member). The trustee's success in investing the CRT assets may be met with diffidence by the annuity beneficiary of a CRAT, who generally is less concerned about investments unless the CRAT were to become so depleted it could not pay its annuity obligation. The unitrust beneficiary of a CRUT, whose annual payment varies with the annual valuation, and the charity in any case are vitally concerned with the CRT's overall investment success.

Balancing the interests of the parties can raise difficult issues for the trustee. For example, in the case of a CRAT, the annuitant may prefer investments that are so safe they are inconsistent with maximizing the trust's total return over the life of the trust. In the case of a CRUT with an income limitation, the unitrust recipient may prefer income that avoids a current limitation on the payout. Using investments that maximize current income (often bonds and high-yield stocks) may prejudice the charity's interest in that such investments may be inconsistent with long-term investing that maximizes total return (balance of equity, debt, growth, etc.).

The trustee must be the one to make these investment decisions. The tax regulations provide that "a trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets". Reg. Sec. 1.664-1(a)(3). So the donor cannot indirectly control investments via the trust document or mandate that donated assets are to be retained rather than sold. In a private letter ruling, the IRS concluded that a CRT is not qualified if the trust document goes too far in delegating investment responsibility to an investment advisor, absolving the trustee of investment responsibility. PLR 8041100.

On the other hand, state law may stress the importance of the trustee seeking competent investment counsel. Many states impose a "prudent investor" standard in formulating and monitoring the CRT's investment strategy. For example, state law may (subject to possible exceptions) impose a diversification requirement.

VII. Avoiding Unrelated Business Income

The CRT is generally exempt from tax, but it will be required to pay excise tax of 100% for every dollar of unrelated business taxable income. IRC Sec. 664(c)(2)(A).

The trustee needs to know these rules in order to avoid problems for the trust. For example, apartment rentals generally generate passive income and avoid the unrelated business income tax classification, but apartment buildings may have activities that raise unrelated business income (UBI) problems, such as income (specifically quarters) generated from a laundry room. Also, rentals from hotels "or apartment houses furnishing hotel services" are too active and trigger the UBI problem. Reg. Sec. 1.512(b)-1(c)(5).

Another example is that income from "working interests" in oil and gas properties generally triggers UBI problems. Reg. Sec. 1.512(b)-1(b); Rev. Rul. 69-179, 1969-1 C.B. 158.

Furthermore, debt often triggers UBI problems; e.g., margin accounts are generally to be avoided. See, e.g., Rev. Rul. 74-197, 1974-1 C.B. 143; *Elliott Knitwear Profit Sharing Plan*, 614 F.2d 347 (CA-3, 1980). Brokers have been known to want to make loans for a few days as the trust's contributions "dribble in." Because any unrelated business taxable income will incur a 100% excise tax, the trustee should warn the broker not to make such loans, even for a few days.

And an issue that can sometimes arise, typically in a real estate context, is whether an asset sold is "dealer property." The tax rules try to distinguish realty held for investment from realty that has become "inventory" held for sale. Typically, the courts will look at the degree of development activity. There are a number of cases dealing with this issue in various circumstances, typically for the purpose of determining whether gain is ordinary income or long-term capital gain. In a CRT context, the issue can not only determine the character of the trust's income (ordinary income vs. capital gain) but whether the income is actually unrelated business income.

VIII. Measuring Fiduciary Accounting Income

A CRUT (but not a CRAT) is permitted to have an income limitation: the trustee may pay out only net income if that is less than the unitrust amount. The basic nature of the income limitation is that it is a limitation which can hurt the income beneficiary and ultimately shift more assets to the charity, a contingency which does not increase the income tax deduction. If the trust contains a make-up provision, as is typical, the limitation may be mitigated by the presence of significant accounting income in a later year that "turns around" the prior limitations. So it is possible that the trustee's discretion in measuring fiduciary accounting income will affect the timing and/or the amount of payments to the trust's unitrust beneficiary.

The trustee may have limited discretion in measuring the trust's fiduciary accounting income, making judgments within the parameters of state law and the terms of the trust. The fiduciary accounting income concept can affect payouts and thus have tax consequences, although it is not a tax law concept per se. Also, it is not the same as measuring accounting income under generally accepted accounting principles.

At times, the tax rules have something to say about what will be acceptable in measuring fiduciary accounting income. IRS regulations provide: "Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized". Reg. Sec. 1.664-3(a)(1)(i)(b)(3).

IX. Allocating Capital Gains

Does the trustee have discretion in allocating the character of income? For example, if there are two beneficiaries and one is in a low tax bracket, can the trust provide that the trustee is to allocate the trust's ordinary income to the low-bracket beneficiary and long-term capital gains to the other beneficiary? This isn't permissible. IRS regulations require that if there are multiple beneficiaries, each receives a pro-rata share of each class of income distributed. Reg. Sec. 1.664-1(d)(3). For example, if one beneficiary receives \$3,000 and another receives \$2,000, the first beneficiary receives 60% of the total distributions and will report 60% of any ordinary income considered to have been distributed.

An issue that may significantly affect fiduciary accounting income, an issue that has a complex history, is the allocation of capital gains between principal and income. IRS regulations provide that "Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution". Reg. Sec. 1.664-3(a)(1)(i)(b)(3).

While this allocates pre-contribution gain to principal, it does not require all gains from contributed property to be allocated to principal. The regulations also acknowledge that "the governing instrument, if permitted under applicable local law, may allow the allocation of post-contribution capital gains to trust income."

However, it is also true that post-contribution appreciation, and even appreciation after an asset is purchased, cannot be defined as "income" pursuant to discretionary power granted to the trustee.

To avoid an income limitation and still treat the charity fairly, it may be necessary to allocate some capital gains (usually from equity investments) to fiduciary accounting income. This presumes that in order to treat the remainder beneficiary (the charity) fairly, the trustee is required by the fiduciary standards of the state (barring an exception) to invest in

equities. Modern investment theory dictates that long-term rates of return are not maximized without some equity (more risky) investments. Also, in a very low interest rate environment, it may not be possible to avoid the income limitation even if the trust is wholly invested in relatively low-risk debt instruments.

If the CRUT has an income limitation, there are issues of conflicts of interest both as to selecting investments and measuring fiduciary income whenever the trustee is beneficiary; e.g., the donor-trustee retains the income interest or the charity is trustee.

Local law will prevail, but note that under the Uniform Principal & Income Act, the trustee that is a beneficiary may not even be permitted, absent an overriding provision in the trust, to adjust principal and income. Uniform Principal & Income Act, Sec. 103, 104.

The non-professional trustee may be able to resolve issues concerning the measure of the income limitation with professional help, but the donor may want to consider installing a professional trustee at the outset if there are sure to be significant issues of measuring the income limitation.

Note that the IRS continues its policy that it will not ordinarily rule on whether a CRT is qualified "when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under IRC Sec. 643(b) and income for federal income tax purposes for the benefit of the unitrust recipient". Rev. Proc. 2003-3, 2003-1 C.B. 113.

Generally, the IRS concern here is that only distributions from the entity or annuity contract to the CRT may be defined as fiduciary accounting income, which allows the insiders to control distributions and the measure of accounting income, thus controlling whether or when to activate the NIMCRUT's make-up account—the "spigot" in this scenario. This determines distributions to the beneficiary, as well as the timing and amount of the beneficiary's taxable income.

X. Making Distributions to Non-Charitable Beneficiaries

Generally speaking, the trustee has to distribute the payout to non-charitable beneficiaries (annuity or unitrust amount) before the end of the year. However, for both CRAT and CRUT, the time to make the required distribution can go beyond the end of the year under certain circumstances. Reg. Sec. 1.664-2(a)(1)(i) and Reg. Sec. 1.664-3(a)(1)(i). The trustee needs to be on top of such matters from the very inception of the trust.

The trustee may also have to deal with such issues as expense allocations among the four-tier reporting categories.

While many of these issues are often shifted to the administrator, the trustee should be apprised of significant issues and be prepared to pass judgment on them.

Besides tax reporting, the trustee will also want to resolve what responsibilities there may be for reporting to the beneficiaries.

The rules governing the character of income flowing to the income beneficiary should also be understood in structuring the trust's investments. Does the trustee even have a fiduciary responsibility under state law to stay informed regarding the beneficiary's tax position?

The tax rules provide that income flows out of the tax-exempt trust to the income beneficiary in the following order: ordinary income, capital gains, exempt income, then return of capital.

Even if the beneficiary prefers to receive tax-exempt municipal bond income, this often isn't possible. For example, if the trust realized a \$500,000 capital gain on the donated asset and has realized \$50,000 of ordinary income, the trust would have to distribute \$550,000 before it could distribute any muni-bond income.

If the CRT was funded with cash and invested solely in municipal bonds that were not sold at a gain, the tax rules would flow-through the exempt income. However, there are issues of diversification, and the issue of yields on muni-bonds being so low that they could be prejudicial to the income beneficiary against the charity's interests.

The trustee will also need to monitor the trust's cash flow requirements. A CRAT must distribute the annuity no less often than annually, and the CRUT must distribute the unitrust amount at least annually unless an income limitation applies. If the income limitation is subject to a make-up provision, the NIMCRUT may be required to make an unusually large distribution in a year in which there is significant accounting income.

The basic nature of distributions from CRTs is that (most often) they are mandatory and objectively calculated. In the initial year of the trust and in the year in which the income interests terminate, there is a proration of the annuity or unitrust amount. These circumstances complicate the calculations and require some knowledge of the tax rules, but the payouts are nevertheless objectively measured.

The CRT cannot be invaded for emergencies, and so it should not be funded with assets the family (as non-charitable beneficiaries) may need in an emergency. The rules governing CRTs are so strictly applied that a provision allocating \$1,000 to an account to provide gravesite flowers has been held to be sufficient to disqualify the trust. In PLR 8311051, the Service reasoned that "such action by the trustee of the trust is not within the prescribed activity of a trust functioning exclusively as a charitable remainder unitrust."

With a CRT, the beneficiary usually does not have to make a case for special needs or the appropriateness of attending a more expensive college, or argue for a level of distributions that are necessary to maintain an accustomed life-style.

On the other hand, such arguments may arise if the CRT's trustee is to make choices among the beneficiaries. If a CRAT or CRUT permits the trustee to "sprinkle" income among beneficiaries, an independent trustee is necessary. Rev. Rul. 77-73, 1977-1 C.B. 175; Rev. Rul. 77-285, 1977-2 C.B. 213; Rev. Rul. 77-395, 1972-2 C.B. 340, Sec. 5.03, 7.03.

"Premature distributions" to charity usually require careful review but it is possible that the trust might give the trustee discretion to make distributions to charity prior to the termination of the trust. If premature distributions to charity are permitted under the terms of the trust, it may be inappropriate to name the charity as trustee due to the inherent conflict of interest.

XI. Performing Administrative Functions

One of the trustee's responsibilities will be filing necessary tax returns relating to the trust. The trust typically files at least two federal forms with the IRS (Forms 5227 and 1041-A) and often files a form(s) with the state as well. Usually, such forms are merely to report income that flows through to the beneficiary's return. The beneficiary is notified of the amount and character of flow-through items. The details are often delegated to a CPA or professional administrator, but the trustee is the one responsible for the trust's tax reporting.

The trustee may also want to take all practical steps to secure cooperation of other parties who may have relevant information pertaining to the administration of the trust, such as notification of the death of a beneficiary, and if the donor retains a testamentary right to revoke a beneficiary's interest, whether such right was exercised. CRT agreements sometimes provide that the trustee is permitted to assume the testamentary right to revoke was not exercised absent notification of the exercise of such right.

Similarly, if the trust provides that a beneficiary's interest is terminated upon the happening of a qualified contingency as defined under IRC Sec. 664(f), the trustee should make arrangements to be notified if the contingency occurs.

XII. Conclusion

A key word to keep in mind in selecting the trustee of a CRT is "appropriate." To choose the appropriate trustee for the CRT involves matching skills and duties, and weighing any number of factors that may be unique to the trust and its anticipated operations.

T H E
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