

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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