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A charitable remainder trust (CRT) is nothing more than a trust with one or more charities as its remainder beneficiary(ies). When a donor establishes such a trust, it will typically be a *qualified* CRT, meaning it meets a number of different requirements that result in various federal tax benefits for both the donor and the trust itself. If those benefits are of little or no value, however, then a host of planning opportunities becomes available to donors who want to customize their CRTs.

Qualified CRT Basics

The mother ship for qualified CRT requirements is section 664 of the Internal Revenue Code (IRC). Other important requirements are set forth in Regulations adopted by the Treasury Department pursuant to IRC section 664. Further guidance can be found in numerous rulings issued by the Internal Revenue Service (IRS) during the last several decades. In addition, IRS Revenue Procedures dating from 2003 and 2005 provide very practical help for those seeking to draft documents that will create qualified CRTs.

In order to be qualified, a CRT must meet all relevant requirements. Getting things right the first time is pretty much essential, as options for amending a trust instrument designed to create a qualified CRT are fairly limited. Moreover, once established, a qualified CRT – if it is to remain qualified – must continue to be administered as such throughout its existence.

The primary rewards for setting up and maintaining a qualified CRT are a charitable tax deduction for the donor and tax-exempt status for the trust. A corollary of this second reward is that capital gain assets contributed to a qualified CRT by a donor can subsequently be sold without either the donor or the trust having to pay tax on the gain. Of course, if, as is often the case, the donor is a beneficiary of the payments made by the trust each year, some or all of the gain will likely flow out to him or her as taxable income over the years.

Thus, the possibility of opting for a non-qualified CRT becomes more realistic the less a donor cares about receiving a tax deduction or having the trust be tax-exempt. Similarly, in some cases a donor may really want to establish a qualified CRT, yet he or she gets hung up on one or more of the requirements. Knowing that

the donor has a choice, even if it may be a choice between two less than ideal alternatives, allows for an analysis of which road would be the best one to go down. In short, gift planners should keep in mind that not every CRT needs to be a qualified CRT.

Even though a comprehensive review of all the detailed requirements associated with having a CRT be qualified is beyond the scope of this article, the following sections highlight a number of them. Naturally, in any situation in which a CRT, whether qualified or non-qualified, is being contemplated, the gift planner and the donor – as well as any third-party trustee – should consult knowledgeable sources of information and rely on the advice of legal and tax counsel in actually forming and operating a CRT.

CRAT? CRUT? Who cares?!

IRC section 664 requires that a qualified CRT be structured in one of only two permissible ways: as a charitable remainder annuity trust (CRAT) or as a charitable remainder unitrust (CRUT). A CRAT pays the trust's income beneficiary(ies) the same fixed amount each year (often expressed as a fixed percentage of the initial value of the trust's assets), even if principal must be invaded. By contrast, each year a CRUT pays a fixed percentage of the value of the trust's assets as that value changes from year to year, again, even if principal must be invaded. A donor may make additions to a CRUT, but not to a CRAT.

A CRUT structured as just described is known as a standard CRUT (SCRUT). A CRUT can also be structured to pay the lesser of the standard percentage amount for the year or the actual net income earned that year, in which case it is referred to as a net-income CRUT (NICRUT). A further variation on a NICRUT, a net-income with make-up CRUT (NIMCRUT), allows for possible payment of a "make-up" amount in a year when net income exceeds the standard percentage amount, to the extent that in one or more prior years net income was less than the standard percentage amount. It is even possible to have a so-called "flip" CRUT that starts out as a NICRUT or NIMCRUT but then becomes a SCRUT as of the beginning of the year following the year in which one of a limited group of "triggering events" occurs. Trust principal cannot be invaded to make beneficiary payments in the case of a NICRUT, a NIMCRUT, or a flip CRUT during the period before the flip.

While the foregoing might make it seem like a donor has a fair number of options in structuring a trust and still having it be a qualified CRT, many more options become available if the trust does not need to be qualified. Examples include a CRT that pays the income beneficiary(ies):

- strictly net income
- the greater of net income or a unitrust percentage amount (or an annuity amount)
- the lesser of net income or an annuity amount
- an annuity amount that increases (or decreases or otherwise varies) from one year to the next, with the donor able to make additional contributions to the trust at any time
- an annuity amount for a period of time, followed by a unitrust percentage amount (or vice-versa), with the triggering event for the flip being whatever the donor specifies
- an amount determined in the discretion of the trustee

One's imagination might truly run wild, were it not for the fact that because a non-qualified CRT is a taxable entity, the trust will need to pay tax on any net income it does not distribute each year. Fortunately, neither of the first two hypothetical structures described above should pose a problem. The first one in particular has long been a popular choice for those who want a trust that is potentially taxable to be *de facto* tax-exempt because it distributes all of its net income. In fact, the same approach is part of what keeps a pooled income fund from paying tax on any of the income it earns.

Even though most donors establish CRTs during their lifetimes, a testamentary trust is also an option. Due to the step-up in basis accorded capital assets at the time of the owner's death, the avoidance of capital gains taxation afforded by a qualified CRT is of no benefit, at least in connection with a CRT's sale of the estate assets used to fund the trust initially. Thus, a testamentary CRT structured to pay no tax on its investment income will likely be able to avoid as well recognizing any taxable capital gain by selling its funding assets promptly.

Provided the realization of any future capital gain income can be minimized, the fact that such a CRT is not qualified should not be a significant impediment, especially if the donor's estate will not be subject to estate tax and therefore not able to benefit from the charitable deduction associated with funding of the trust. All of this makes establishing a thoughtfully structured and administered non-qualified CRT upon death a very realistic alternative to a qualified testamentary CRT.

Transcending Payout Rate Limitations

A qualified CRAT must pay an annuity amount that is at least 5 percent and no more than 50 percent of the initial value of the trust's assets. Likewise, the unitrust percentage associated with a qualified CRUT must also fall between 5 and 50. As already discussed, a non-qualified CRT is not limited to paying strictly an annuity amount or a unitrust amount, but if a donor were drawn to either of those two approaches in structuring a non-qualified CRT, no percentage limitations would apply. In that event, a wise gift planner obviously would steer the donor toward the range below 5 percent, rather than the range above 50 percent. Keep in mind, however, that the lower the payout rate, the more likely that in one or more given years the trust would have net income in excess of the amount paid out, thereby incurring a tax.

Of course, if the trustee of a CRT were not constrained by a fixed, minimum payout rate, the trust could hold nothing but tax-exempt bonds and then simply pay the income beneficiaries the interest earned by the bonds, thereby ensuring there would be no taxable income, unless for some reason any of the bonds were sold at a gain. A further benefit is that the income beneficiary(ies) would owe no tax on the interest paid out by the trust. As it is, however, in the current interest rate environment a qualified CRAT or SCRUT with even a 5-percent payout rate that owns nothing but tax-exempt bonds will probably need to liquidate some of its holdings each year in order to have enough cash to make the required (possibly partially taxable in the hands of the beneficiary(ies)) payments, rendering questionable such an investment approach.

He (or She) Who Throws the Party Invites the Guests

Another requirement of a qualified CRT is that the present value of the remainder interest (as calculated using certain factors dictated by law, including mortality data and/or the specific number of years the trust will last) attributable to any

contribution of assets to the trust be at least 10 percent of the value of those assets. In practice this means that a CRUT with a 5-percent payout rate lasting for the lifetime of anyone much under age 27 will not be qualified. Higher minimum ages will apply when the trust is to last for the lives of two or more individuals. In the case of a CRAT, a separate requirement that the trust have no more than a 5-percent chance of exhausting its assets before it ends means that, at least in the current era of low interest rates, a trust with 5-percent payout rate lasting for the lifetime of anyone much under age 75 will not be qualified. Here again, higher minimum ages will apply when the trust is to last for the lives of two or more individuals.

Wouldn't it be nice if these considerations could be ignored? Happily, they can be with a non-qualified CRT, freeing the donor to name as many income beneficiaries as desired and to pick whatever trust term he or she wishes, consistent with not violating state law regarding how long a trust with non-charitable beneficiaries may last.

Similarly, a non-qualified CRT affords flexibility as to which remainder beneficiaries are on the "guest list." True, with a qualified CRT a donor can reserve the right to change the remainder beneficiaries over time. Still, each such beneficiary must be a "qualified charitable organization" as defined in various portions of the IRC. In addition, whereas the income interest of a qualified CRT may be shared by charitable and non-charitable beneficiaries, that is not an option with the remainder interest. By contrast, a non-qualified CRT can mix and match charitable and non-charitable beneficiaries of either or both interests. Even if charities are the only beneficiaries of the remainder interest, none of them needs to be a qualified charity. This enables a CRT to support foreign charities and/or domestic ones that, for whatever reason, do not have qualified status.

Beyond Irrevocability

A qualified CRT must be irrevocable. It can be amended, but generally only to a modest extent in tightly prescribed circumstances. A non-qualified CRT, on the other hand, could be either completely revocable (in which case, it would likely be regarded as a grantor trust, meaning that the donor – or whoever could exercise the power to revoke in their favor – would be taxed on all the trust's income) or at least amendable to a greater extent than in the case of a qualified CRT.

Revocable CRTs are really nothing new. If a donor establishes a revocable living trust that, upon the donor's death, distributes all its assets to one or more charities, this essentially is a revocable CRT. Only upon the donor's death does the trust become irrevocable, although in concept what the donor has ultimately done is simply make a bequest through a living trust, rather than through his or her will.

Harnessing Trusts Set up to “Qualify” for Other Purposes

Focusing once again on ways donors have long been using non-qualified CRTs to support charities, gift planners should be aware that both so-called QTIP trusts and special needs trusts can be structured as CRTs, so long as they “qualify” in terms of meeting requirements separate from those related to IRC section 664.

A QTIP (which stands for “qualified terminable interest property”) trust is typically established upon the death of the first of two spouses to die. The surviving spouse is the sole income beneficiary, and the trust lasts for the balance of his or her life. Each year the trust pays out all of its net income (thereby eliminating the need for the trust to pay income tax), plus in certain instances the surviving spouse can even have access to a portion of the principal. Whatever is left in the trust upon termination is distributed to one or more beneficiaries, usually any children of the first spouse to die (who may or may not be children of the surviving spouse) who may still be living.

The primary tax objective of a QTIP trust is to postpone until the death of the surviving spouse the imposition of estate tax on the assets held by the trust (valued as of the date of the surviving spouse's death, not as of the date of death of the first of the spouses to die). This effectively increases the value and, hence, the estate tax liability of the surviving spouse's estate. Nevertheless, to the extent that the remainder beneficiaries of the QTIP trust are qualified charities, rather than non-charitable entities, every dollar distributed to charity from the trust will be deductible for estate tax purposes. Indeed, sometimes a donor will actually make the full remainder distributable to charity, in which case the trust is referred to as “charitable QTIP trust.”

A special needs trust has as its income beneficiary an individual with some form of physical or mental disability that entitles the individual to receive public assistance of one kind or another. The primary objective of the trust is to provide as much financial support to the disabled individual as possible without providing “too much”

in terms of the individual suddenly ceasing to qualify for public assistance. Depending on any number of factors, this could well result in the trust distributing in any given year something less than its net income, meaning that the trust will owe some income tax for that year.

Such a trust is often established by parents or other relatives of the disabled individual, sometimes during their lives and sometimes upon death. The trust lasts for the life of the disabled individual. When the trust ends, whatever remains frequently is returned to the family, but having a charity receive some or even all of the remainder is also a possibility. Normally, such a distribution will not produce any charitable deduction. Still, the donor(s) will take comfort in knowing that any remaining assets will be used to serve a charitable purpose, perhaps in particular benefiting one or more organizations that provided services to the disabled person while he or she was living.

Conclusion

For all sorts of good reasons, most CRTs that donors establish in the years to come will continue to be qualified CRTs. In any particular instance, however, a donor's objectives might turn out to be met better with a non-qualified CRT.

This is most likely to be so when a donor is contemplating a testamentary CRT, in light of the large exemption from federal estate tax that almost all donors currently enjoy and that nullifies for all but the wealthiest of donors the benefit of the estate tax charitable deduction associated with a qualified testamentary CRT. If the trust can be administered in a way that minimizes or eliminates the income tax it must pay, then the benefit afforded by the tax-exempt nature of a qualified CRT is also either significantly or completely nullified.

Non-qualified CRTs established by donors during life face somewhat higher hurdles. Yet if a donor would not derive much benefit from the income tax charitable deduction associated with a qualified *inter vivos* CRT, or if the donor strongly objects to having to comply with one or more of a qualified CRT's requirements, then exploring establishment of a non-qualified CRT becomes worthwhile, provided the taxable nature of a non-qualified CRT can be addressed suitably.

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