

New Restrictions on CRTs Make Planning More Important

Charitable remainder trusts (CRTs) are a popular estate planning tool. Why? Because they allow you to turn non-income-producing assets into income-producing assets, take a tax deduction and avoid capital gains tax — all while making a gift to your favorite charity. The Taxpayer Relief Act of 1997 places new limits on CRTs that may preclude a number of options. Nevertheless, with careful planning, CRTs remain a valuable tool.

A CRT is an irrevocable trust that creates two distinct interests: the income interest and the remainder interest. As grantor, you can retain the income interest or designate someone else to receive it for a term of years or life. The remainder interest goes to one or more qualified charitable organizations at the end of the trust term. A CRT offers two main tax advantages:

1. You, as grantor, are entitled to a deduction for income, gift and estate tax purposes for the present value of the remainder interest given to charity.

2. Because the CRT is exempt from federal income taxes, any gain that results from the sale of the property by the CRT will not be taxed to the trust.

You can choose from two types of CRTs: annuity trusts (CRATs) and unitrusts (CRUTs). CRAT payments are based on the value of the assets at the time you contribute them. Thus, the payments will remain the same each year.

CRUT payments are recomputed annually based on the assets' current value, so the payments will vary. One advantage of CRUTs is that, unlike CRATs, they can receive additional contributions after you have created them.

New Limit: The 10% Rule

The Act puts a new limit on CRTs that may have a significant impact: The present value of the remainder interest in a CRT must be at least 10% of the net fair market value of the property as of the date you contribute the

property to the trust. The remainder is calculated considering the term, the annuity or unitrust percentage, and the interest rate prescribed by the Internal Revenue Service (the “discount rate”).

The Internal Revenue Code now requires the value of the remainder interest in a CRAT to be at least 10% of the initial fair market value of the property placed in the trust. Because CRATs are not permitted to receive additional contributions, the 10% rule applies only once — when it is created. For CRUTs, the 10% test applies separately for each contribution. Thus, a contribution in one year may qualify while a later contribution may fail the 10% test.

The Impact

The technical result of the 10% test is to disqualify the accelerated (i.e., high-yield, short-term) CRT. The actual result, however, may be more far-reaching. The test will preclude many planning options, including trusts created for young beneficiaries, relatively large numbers of beneficiaries or large payouts.

For instance, Sandy, age 40, could not create a CRUT with \$1 million on Jan. 1, 1998, and retain an 8% unitrust interest for life (payable

at the end of each quarter). Why? Because, assuming a discount rate of 7.4%, the remainder interest would be \$96,920 or 9.692% — less than 10%.

With more than one beneficiary, creating a CRT for life will be even more difficult. For example, on Jan. 1, 1998, Leo, age 55, and Lena, age 50, create a CRUT that provides for unitrust amount to be paid at the end of each quarter to them together during their joint lives, and to the surviving spouse during the rest of his or her life. If the unitrust amount is 8%, the trust fails. The unitrust percentage could be at most 7.7% of the annual value of the trust assets to have a remainder interest greater than 10%.

Using a 7.6% discount rate and a single payout at year end, here are three trust payout schedules that would still qualify a trust as a CRUT:

- 50% payout for three years,
- 18% payout for the lives of two 73-year-olds, and
- 20% payout for the life of a 62-year-old.

If a CRT is qualified in all other respects but flunks the new 10% test, the grantor has a choice: either declare the CRT null and void

from the beginning or reform it to meet the 10% test by reducing the size of the payouts, the duration of the trust or both to the extent necessary to satisfy the new requirements.

More CRT Changes

- Prior law required CRT payouts to be at least 5% of the value of the trust. Under the Act, definitions of both the CRAT and the CRUT have been amended to change the payout restrictions to at least 5% but no more than 50%.
- In limited circumstances, an employee stock ownership plan (ESOP) may be the CRT remainder beneficiary.
- A CRT cannot hold S corporation stock as an electing small business trust (ESBT).

Can a CRT Still Benefit You?

Despite the new rules, the CRT remains a valuable planning tool, particularly if you are contributing an appreciated asset. The CRT also remains an effective way to avoid tax on items of income in respect of a decedent (IRD). Now it just requires more careful planning.

Please let us know if you have any questions about the new CRT restrictions. We would be pleased to discuss how a CRT could benefit you.