**Between the Issues**

# Investing the Assets of a Charitable Remainder Unitrust

**By Barton J. Bradshaw, J.D.**

A charitable remainder trust (CRT) may be structured many different ways, and a number of key issues must be addressed in their design, implementation and management. The decision-making process may include the donor, the trustee, their legal, tax and financial advisors, and often the charitable beneficiaries. This article will focus on the role of the financial advisor and the concerns faced by the advisor when investing trust assets in a charitable remainder unitrust (CRUT).

The two basic types of CRTs are the charitable remainder annuity trust (CRAT), and the charitable remainder unitrust (CRUT). There are also several variations of the CRUT that allow for flexibility in the amount and/or timing of distributions or for changing CRUT type due to a triggering event. Let's begin with a brief description of each of the common CRUT forms:

**CRUT.** A CRUT (also referred to as a "Standard CRUT") provides payments at least annually to a non-charitable beneficiary based on an annual valuation of the trust assets, with any remainder interest to be paid to or for the benefit of a charity. Payments can be based on the life of the income beneficiary or for a fixed term of years (not more than twenty). Because the trust is revalued annually, additional contributions by the donor are permitted. The payout must be a fixed percentage, established at the trust's inception, which is neither less than 5 percent nor more than 50 percent of the net fair market value of the trust assets.[1] The maximum payout is further limited by the "10 percent remainder test."[2]

**NICRUT.** A net-income charitable remainder trust (NICRUT) works just like a regular CRUT, except that the income beneficiary receives each year the lesser of the fixed percentage of the value of the trust assets, or the net income earned by the trust during the year.

**NIMCRUT.** With a net income makeup charitable remainder unitrust (NIMCRUT) if the trust's net income for a year is less than the fixed percentage, the income beneficiary only gets the net income for the year—the trustee cannot use trust principal to make up the shortfall. The difference between what should have been paid and what was in fact paid is recorded in a make-up account.[3] In a subsequent year, if the trust has net income greater than the fixed percentage, the trust distributes the fixed percentage amount for that year, plus any balance in the make-up account to the extent that the total distribution for the year does not exceed the trust's net income for that year.

**FLIP Unitrust.** A flip unitrust starts out as either a NICRUT or NIMCRUT, and then changes to a CRUT upon a triggering event identified in the agreement. To qualify, this trigger must be set for a specific date or a single non-discretionary event.[4]

## Issues to Consider

There's an old Florida expression that goes something like, "It won't be the gator you see that'll be the one that eats you." It's a good thing to keep in mind if you're swimming in Lake Okeechobee, but its message also applies to other situations as well. When you're investing assets in a CRT, for example, there are many potential pitfalls, and it is often the one that gets overlooked that trips things up. To find out where those alligators might be lurking, let's examine some of the important issues involved with investing CRUT assets.

### Restricted Trust Investment Language

Be sure to carefully read the agreement[5] before agreeing to make CRT investment recommendations to the trustee. One of the reasons is that, although the donor may express a non-binding preference, the trust agreement generally cannot restrict the trust to specific types of investments[6], such as tax-free municipal bonds[7] or deferred annuities, otherwise the trust may lose its tax-exempt status.

There are a few exceptions to this rule. Trust language can prohibit the trustee from purchasing certain identified investments considered to be immoral or unethical by the donor. A trust generally may also restrict the trustee from investing in hard-to-value assets, such as closely held stock.

**Self Dealing**
Certain activities, known as self-dealing, are prohibited. The donor, the trustee (if separate from the donor), members of their families, and entities in which they have substantial interests are "disqualified persons" and are prohibited from dealing with the trust (the trustee obviously deals with the trust, but not for personal gain). Self-dealing might include situations such as a trustee lending trust assets to himself, buying property from the donor's family, or buying a life-only immediate annuity that guarantees that no money will be left for the charitable remainder beneficiary.

If the donor is also going to be the trustee, and the trust is going to be funded with assets that are not easily marketable, such as an immediate annuity or an interest in a closely held corporation, a qualified independent appraiser will need to be used to value those assets[8].

The purchase of a deferred annuity contract has been held not to be a prohibited act of self-dealing by a NIMCRUT.[9]

**Trust Payouts**
Going with the highest trust payout allowed may seem like a good approach (particularly for the income beneficiary), but is it? An unreasonably high payout percentage in a CRUT may result in the income beneficiary's payment stream rapidly declining in later years. When determining the appropriate percentage to use, it is important to take into account reasonable expectations for investment results, along with projected legal, accounting and trust administration expenses, as well as investment management fees. In addition, where the CRUT is paying a life income, the trustee needs to consider the possibility that the income beneficiary will outlive his life expectancy.

*Example:* a CRUT which promises an annual payout of 9 percent may have to achieve a much higher gross return due to internal costs in order to pay a net 9 percent without dipping into principal. In order to keep pace with inflation, the investment return would need to be higher still. In reality, a CRUT which offers a payout in excess of 6 to 7 percent may be hard pressed in later years to meet its commitments.

**Unrelated Business Taxable Income (UBTI)**
Unrelated business taxable income is generally income the trust receives from debt-financed assets. Examples of assets that may generate UBTI include mortgaged real estate, closely held stock where the trust owns a controlling interest, interests in certain limited liability companies and partnerships, securities purchased on margin, and hedge funds.

Under prior law, a CRT lost its tax-exempt status for any year in which it had UBTI. The results could be harsh—even one dollar of UBTI could cause the trust to lose its tax-exempt status for the entire year. The new law, enacted in 2006, imposes a 100 percent excise tax on any UBTI generated by a CRT, but does not cause the CRT to lose its tax-exempt status.[10]

**Income Tax Expectations**
Donors need to understand that a CRT is not a way to eliminate capital gains taxes on the donated assets. The CRT only defers these capital gains. Payouts from the trust are taxed to the income beneficiary under a four-tier ordering system in which distributions are treated as first coming from ordinary income (Tier One), then from capital gains (Tier Two), then from tax-exempt income (Tier Three), and finally from trust principal (Tier Four).

*Example:* A donor has stock worth $1 million that he contributes to a CRUT. His cost basis is only $100,000, so there is a lot of unrecognized gain. The donor, as income beneficiary, wants to receive only tax-free income from the trust. The trustee sells the assets (without having to pay capital gains taxes) and then reinvests the proceeds in municipal bonds, which will generate tax-exempt income to the trust. Will this result in the income beneficiary receiving a tax-free payout? No. Even though the underlying investment generates tax-exempt income, the trust has to first exhaust all Tier One and Tier Two income before distributions will be treated as tax-exempt (Tier Three). In other words, assuming that the trust generates only tax-exempt income, the first $900,000 it pays to the income beneficiary will be taxed as capital gains.

The bottom line is that the donor (and income beneficiaries, if not the same) need to understand how they will be taxed on their trust payouts from the start.

## Peaks and Valleys

Investment volatility can cause problems in a CRUT because the trust has to be revalued *and* make distributions annually. If the value of the asset is high when it is valued, but falls when a distribution must be made, the trust may be required to distribute principal to cover its payout obligation. This means that the next year the trust investments will have to perform at an even higher level to make up for the reduced asset base. Nor is it good for the portfolio to consistently hit high points at valuation time each year, as long term, this will likely result in a reduction in total distributions.[11] As a general rule, a stable investment return will provide both greater income and a larger remainder interest.

## Balancing the Needs of Both the Income and Remainder Beneficiaries

The income beneficiary will usually want the trust assets managed to ensure maximum payout and minimum tax liability. This might be achieved, for example, by using an aggressive growth oriented investment portfolio that offers the possibility of high returns and primarily Tier Two (capital gains) income. The downside is that it increases volatility and places the principal at greater risk. Contrast this with the needs of the charitable beneficiary, who may instead want trust assets managed to preserve the maximum amount of remainder interest. The charity would prefer a very conservative portfolio that would protect principal, but likely also limit the growth of the trust and ensure that mostly Tier One (ordinary) income was generated. The job of the trustee is to balance the needs of both.

Most states have adopted the "prudent investor rule." This rule requires that, "A trustee shall diversify the investments of the trust unless the trustee reasonably believes that, because of special circumstances, the purposes of the trust are better served without diversifying."[12]

## Deferred Annuities

A deferred annuity may be effective as an investment for a NIMCRUT. If permitted, income accumulates in the deferred annuity contract until such time as the trustee takes a distribution. This would allow the trustee to regulate the flow of income from the NIMCRUT in its later years to meet the needs of the income beneficiary.

The language of the trust agreement, which must be consistent with applicable state law, determines when to recognize income from a deferred annuity contract (such as only upon a withdrawal from the contract).[13] If the trust is silent as to this issue, then it is determined in accordance with state law. In most states, trust income does not have to be recognized until realized, meaning that it's permissible for it to remain deferred inside the annuity. This gives the trustee a great deal of control over the income when he or she uses a deferred annuity.

Features to consider when investing in a deferred annuity contract:

- Look for a deferred annuity contract that has guarantees. This will ensure that at least some income will be available when it becomes needed.
- Look for contracts that offer flexible withdrawal rights.
- If joint annuitants are to be used, check to be sure the annuity company doesn't force distribution of the contract at the death of the first annuitant. Contracts may vary on this issue.

## In Summary

Investing assets for a charitable remainder unitrust is not as easy as it might seem at first glance. The trustee must ensure that assets are wisely invested so as to provide for both the promised payout to the income beneficiary and the remainder interest for the charitable beneficiary. The trustee has to balance these competing interests, while also complying with state laws, avoiding pitfalls such as inadvertently generating unrelated business taxable income (UBTI), and managing the tax efficiency of the investment mix. Careful planning will help ensure that wise choices are made, and potential hazards avoided.

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**Notes**

[1] IRC §664(d)(2)(A)

[2] IRC §664(d)(2)(D); Treas. Reg. §1.664-3(b). The projected value of the assets to be left to charity must equal at least 10% of the original contribution, based on factors such as the payout rate, length of payout, and ages of the income beneficiaries. Whether the charity will actually receive this amount will depend upon the performance of trust investments and the trust's duration.

[3] A "make-up account" is really just an accounting record which tracks cumulative net income not paid to income beneficiaries.

[4] Treas. Reg. §1.664-3(a)(1)(i)(c)(1)

[5] Interpretations of trust language, including whether certain investments are permitted, should ultimately be made by the trust's legal advisors.

[6] Treas. Reg. §1.664-1(a)(3)

[7] IRS Letter Ruling 7802037

[8] Applies to CRTs created on or after 12/10/98. For CRTs created prior to that date, an independent trustee must be used to value the unmarketable assets.

[9] IRS Letter Ruling 9825001. Unfortunately, the IRS has still not provided final guidance on this issue.

[10] IRC §664(c), as amended by TRHCA 2006

[11] A possible way to smooth out some of these ups and downs (if permitted by the language of the trust) is for the trust to value its assets at several different times during the year, and then use the average value. For consistency, valuations should be performed on the same days each year and using the same methods.

[12] Uniform Prudent Investor Act §3

[13] Treas. Reg. §1.643(b)