WADE ASH
WADE ♦ ASH ♦ WOODS ♦ HILL & FARLEY, P.C.

CHERRY CREEK CENTRE
360 SOUTH MONROE STREET, SUITE 400
DENVER, CO 80209
303.322.8943
WWW.WADEASH.COM

CHARITABLE REMAINDER TRUST

CAUTION:

The purposes of this memorandum are to assist the trustee of a charitable remainder trust, in:

1. Creating the trust and transferring assets to the trust;

2. Maintaining records for the trust; and

3. Filing any required tax returns.

This memorandum only provides *general* information, and any specific questions about a particular trust must be discussed with the attorney.

INTRODUCTION

Part I of this memorandum discusses the documents that are required to create the charitable remainder trust. The most important of those documents is the trust agreement, but there are other documents that must be signed and filed. The purposes of a charitable remainder trust often include (1) creating a tax-exempt entity to minimize income tax on gain from sales of appreciated assets, (2) providing an income stream to the non-charitable beneficiaries during their lifetimes, (3) supporting charities by then passing the trust property to the charitable beneficiaries, (4) obtaining a charitable deduction from income tax for the donor, and (5) removing assets from the donor's estate. A deduction for the present value of the remainder interest passing to charity is also available for gift or estate tax purposes. To obtain these tax advantages, there are a number of formalities that must be observed, both in the creation of the trust and in the continuing administration of the trust.

Part II of this memorandum discusses the continuing qualification of the trust and the filing of any necessary fiduciary income tax returns.

PART I -- CREATING YOUR CHARITABLE REMAINDER TRUST

Trust Agreement

A separate summary may have been prepared outlining the terms of the particular charitable remainder trust agreement. In general, the agreement tells the trustee how to administer the trust. The donor cannot change the trust or any of its terms after it is executed and funded. It must be *irrevocable*, and it must meet strict IRS requirements in order to give the donor the expected tax advantages.

Generally, a charitable remainder trust that meets the IRS definition of either a "charitable remainder unitrust" or a "charitable remainder annuity trust" will be recognized as a tax-exempt entity for income tax purposes. This means that the trust will not pay income tax on income it receives (including gain on sale of assets), although the noncharitable beneficiaries will usually pay income tax on distributions they receive from the trust. In addition, transfers to the trust either during lifetime or at death will qualify for a gift or estate tax charitable deduction, with respect to the value of the remainder interest passing to charity. Transfers to the trust during lifetime will result in an income tax charitable deduction, also for the value of the remainder interest passing to charity.

Both unitrusts and annuity trusts provide for payments to one or more noncharitable beneficiaries (often the grantor of the trust and his or her spouse), for their lives or a fixed number of years. At the end of that time, any remaining trust assets are distributed to one or more charities. An annuity trust provides for the annual payment of a fixed percentage (not less than 5%) of the *initial* fair market value of the trust assets. Additional contributions cannot be made to an annuity trust. A "standard" unitrust also provides for annual payments of a fixed percentage (not less than 5%), but the percentage is applied to the value of the trust assets as redetermined each year. A "net income with make-up" unitrust is like a standard unitrust in that it provides for payment of a percentage of the value of the trust, as redetermined annually. However, if the actual net income of the trust for a year is less than the percentage payout, only the net income is paid for that year. In a later year, if the trust's net income exceeds the percentage payout, then in that year, the excess income is used to make up the deficit from prior years. Additional contributions can be made to unitrusts, although special valuation provisions must be included in the trust agreement. The donor of either an annuity trust or unitrust may retain the right to change the charitable beneficiary in his or her Will.

Unlike most other irrevocable trusts, the donor can be a trustee of a charitable remainder trust without causing tax problems, but if there are assets in a unitrust that are difficult to value, the agreement may provide that there must be an "independent" trustee to value those assets to determine the payout amount for each year. Assets that are difficult to value include real property, stock in closely-held businesses, and other assets other than marketable securities or cash.

The trust agreement must also prohibit the payment of death taxes from the charitable remainder trust. The noncharitable beneficiaries must pay any death taxes attributable to the trust.

Trust Registration Statement

Because the trust is irrevocable, the trustee is required under Colorado law to register the trust with the district court of the county in which the "principal place of administration" is located. The principal place of administration is where the trustee usually keeps the records pertaining to the trust, such as the trustee's usual place of business or the trustee's residence. The purposes of the trust registration statement are to give the current beneficiaries notice of the creation of the trust, and to establish the court that has jurisdiction to hear any dispute concerning the trust. The filing fee is $163. If the trust is not administered in Colorado, this form will not be used, and the law of the state where the trustee is located will control any registration requirements.

Taxpayer Identification Number

The trust must obtain its own federal taxpayer identification number. IRS form SS-4 must be signed by the trustee, which form can then be filed on-line to obtain the taxpayer identification number from the Internal Revenue Service. The IRS will also notify the trustee of the number assigned.

The trust's taxpayer identification number should be used for any bank accounts or investment accounts opened in the name of the trust, and on income tax returns that are filed for the trust.

Transfer of Property to the Trust, and Acquisition of Property by the Trust

In general, the donor should use this format for titling assets in the name of the charitable remainder trust:

The ________________ [name of your trust], dated ___________.

No property may be transferred to a charitable remainder *annuity* trust after the initial funding. Thus, the following discussion applies primarily to the initial transfer of property to an annuity trust, and any transfers to a unitrust.

Identification of Trustees

When the trustee acquires or sells property in the name of the trust, the trustee may be asked to provide evidence of who the trustees are, and who can sign for the trust. The donor or the trustee may, of course, provide a copy of the trust agreement to show that information. However, the donor may not want the trustee to disclose the entire trust agreement.

Usually an institution such as a bank or brokerage house will be satisfied with simply receiving copies of the first page, pertinent pages about trustee powers, and signature pages of the trust agreement, rather than the whole document. Alternatively, a Statement of Authority (discussed below for Real Estate) identifying the trustee can be provided to the companies.

Real Estate

Real estate can generally be transferred to the trust by signing and recording a deed. Colorado law allows real property to be titled in the name of the trust itself (without naming the trustee in the deed), as long as a Statement of Authority is also recorded in the real estate records to show the identity of the trustee(s). If there is a change of trustees, a new Statement of Authority should be recorded to reflect the change before the property is conveyed by the trustee.

Before you transfer any real estate to your trust, there are several special issues that you should consider:

- ♦ If the real estate is subject to any debt (that is, if there is a deed of trust or mortgage against the property), the note and deed of trust or mortgage documents should be checked to see whether there are any restrictions on transferring the property. Those documents may contain a "due on transfer" clause, allowing the lender to accelerate the balance due on the loan if you transfer the property. In such a case, the donor should ask the lender if it will waive its right to accelerate the loan with respect to the transfer to your trust. If a waiver is obtained, be sure it is in writing. In addition, mortgaged real property could cause "unrelated business taxable income" as discussed in Part II.

- ♦ If you transfer real estate located in a state other than Colorado to the trust, you will have to comply with the real estate laws of the state where the property is located. An attorney in that state should be contacted about transferring the property.

Stocks and Bonds

Stocks and Bonds Held in Brokerage Accounts to Be Transferred to Trust

If stocks or bonds are transferred to the trust that are not registered directly in the donor's name, but are held for the donor by a brokerage firm (sometimes called a "street name account"), simply transfer the brokerage account to the trust. The broker will have his or her firm's forms to accomplish the change in title.

Registered Stocks or Bonds

If securities in certificate form are to be transferred to the trust, and if the donor deals regularly with a stock broker, he or she should be able to help handle the paper work to transfer the certificates.

For publicly traded stocks or bonds, the donor's signature on the assignments will need to be guaranteed, which can usually be obtained at a bank or brokerage firm. A signature guarantee is not the same as a notary statement.

There may be buy-sell agreements or other restrictions on the donor's right to transfer stocks or bonds, especially if the company is "closely held." If there are restrictions, it is often possible to obtain a waiver for a transfer to a charitable trust.

Gift and Income Tax Considerations

Before transferring property to the trust, the donor must obtain the value of the property. Because the trust is irrevocable, any property transferred to the trust is a completed gift for gift tax purposes. When you make a gift of property to charity, you receive a charitable deduction for that gift for gift tax purposes. If you give 100% of your interest in the property to charity, no gift tax return need be filed; you simply report the deduction for the gift on your income tax return. However, a charitable remainder trust is a *split-interest* trust, which means that the gift to the trust has a non-charitable portion and a charitable portion. For such gifts, a gift tax return ***must*** be filed for each calendar year in which a gift is made. The gift tax return is made on IRS Form 709, is filed with the Internal Revenue Service, and is due by April 15 of the year following the calendar year in which the gift is made. If the donor extends the due date for his or her 1040, the due date for the 709 is also extended.

Therefore, the donor will need to file a gift tax return for the year in which the charitable remainder trust is funded.

In general, the gift of property to an irrevocable trust is a gift of the total property. However, if the donor as the grantor retains an income interest in the trust, then the value of the interest retained is not a gift. Also, if the donor gives his or her spouse an income interest in the trust, the value of the interest given to the spouse will usually qualify for the marital deduction from gift tax, and will not be taxable. The remainder interest passing to charity after the income interests qualifies for the charitable deduction. Therefore, unless the donor names children or other persons as beneficiaries, there will usually not be any taxable gift even though a gift tax return must be filed.

If unmarketable assets are contributed to the trust, then in order to obtain an income tax charitable deduction, the donor must obtain a "qualified appraisal" from a "qualified appraiser" (as defined in the Treasury Regulations). In later years when the assets must be re-valued to determine the unitrust amount, regulations issued in December 1998 dropped the "qualified appraisal" requirement if there is an "independent trustee." The donor may be the sole trustee of a unitrust, even if it holds unmarketable assets, if the donor obtains qualified appraisals each year. However, if your trust agreement requires an independent trustee in such situations, then the donor will need an independent trustee.

PART II--ADMINISTRATION OF TRUST

Continued Qualification as a Charitable Remainder Trust

Because it is important that a charitable remainder trust continue to qualify as a tax-exempt entity for income tax purposes, care must be taken to comply with IRS requirements during the administration of the trust.

Provisions are included in the trust agreement to avoid "prohibited transactions" under the IRS rules for charitable private foundations (that also apply to charitable remainder trusts). Prohibited transactions can result in severe penalty taxes. The most common examples of prohibited transactions involve "self-dealing" and include, directly or indirectly: the donor (or his family members or business entities) purchasing property from or selling property to the trust; leasing property to or from the trust; and receiving distributions other than as reasonable payment of trustee's fees or in their capacities as noncharitable beneficiaries. Therefore, *the donor must not permit any family member or controlled business entity to engage in transactions such as sales, loans or leases with the trust.* Do not transfer property to a charitable remainder trust that the donor may want to later sell or lease to a family member. The IRS has also ruled that if residential property is transferred to a charitable remainder trust, it must be vacated by the donor before the contribution, or the donor will be deemed to have retained an interest other than a unitrust or annuity interest.

In addition, tax-exempt entities such as charitable remainder trusts cannot receive "unrelated business taxable income ("UBTI")." In any year that such income is received, a 100% penalty tax is imposed. Unrelated business taxable income can arise if the trust has investments that are financed in whole or in part by debt (such as mortgaged real estate), or investments that are publicly traded partnerships or other active business ventures. A charitable remainder trust is not a permitted S corporation stock shareholder, but it could own LLC or partnership interests, but for the UBTI issues.

These rules concerning continued qualification for tax advantages of charitable remainder trusts are very complex.

Income Tax Returns

The trust is required to file federal and state fiduciary income tax returns if the trust has a certain amount of income during a taxable year. The trust is required to use the calendar year as its taxable year. Currently, a trust is required to file income tax returns if, during a taxable year it has gross income of $600 or more, or any amount of taxable income.

The trustee will invest property owned by the trust and may generate significant income and the trustee will be required to file income tax returns to report that income. Because a charitable remainder trust is ordinarily tax-exempt, the trust will calculate net income at the trust level, but will pay no tax. However, the payments to the noncharitable beneficiaries carry out income and are taxed to them. Each payment retains the character of the income as received by the trust, and is treated as first, ordinary income (to the extent of the trust's ordinary income for the current year and undistributed ordinary income from prior years), second, as capital gain (to the extent of the trust's capital gain for the current year and undistributed capital gain from prior years), third, as tax-exempt income (to the extent of the trust's tax-exempt income for the current year and undistributed tax-exempt income from prior years), and finally, as tax-free return of principal.

♦♦♦♦♦♦♦♦♦♦