

MEMORANDUM

TO: OUR CLIENTS AND FRIENDS

FROM: ERIK DRYBURGH

RE: CREATING A CHARITABLE REMAINDER TRUST

This memo is a review of the principles and process of creating and funding a charitable remainder trust (CRT). This memo is not intended to be exhaustive or all-inclusive, but should give you a good overview.

I. BENEFITS OF A CRT. You can obtain the following benefits from creating a CRT:

A. Charitable Contribution Deduction. You can obtain a current income tax deduction for the present value of the remainder interest donated to charity. This deduction is generally based upon the fair market value of property contributed to the CRT, the term of the trust, the payout percentage, and an IRS-provided interest rate.

B. Capital Gain Avoidance. By transferring substantially appreciated property to a CRT, you can avoid paying the capital gain tax which otherwise would be due if you sold the property personally.

C. Lifetime Income Stream. You can retain an income stream for your lifetime(s) or for a term of years (not to exceed 20 years).

D. Charitable Objective. Establishing a CRT can assist you to accomplish your charitable objectives.

II. CREATING THE CRT – STEPS.

A. Gift Design. There are two primary steps in the Gift Design phase – the design of the charitable remainder trust itself, including resolution of technical issues, and an evaluation of the proposed gift property. These steps should be done more-or-less simultaneously.

1. Form of CRT. Review and select the appropriate type of CRT:

(a) Charitable remainder annuity trust: This trust provides for a fixed dollar amount to be distributed to the income beneficiary each year.

(b) Standard charitable remainder unitrust: This trust provides for distribution of a fixed percentage of the fair market value of the trust assets, as re-valued each year.

(c) Net income charitable remainder unitrust: This type of unitrust pays the lesser of the amount determined under (b) above or the net income earned by the trust for the year. This type of trust may also include a “make-up” provision, whereby the trust records a “deficiency” in years in which the distribution is limited to trust income. If the trust earns income in excess of the stated percentage amount in future years, the excess income is paid out to “make-up” the deficiency.

(d) “Flip” unitrust: This type of unitrust addresses the problem facing a donor with an illiquid, low-income producing asset who prefers a standard unitrust over the long term to take advantage of total return investing. A flip trust is a CRT that operates as a net income unitrust while it holds the contributed asset and then switches to a standard payment unitrust after the asset is sold. To qualify, the “flip” must be triggered on a specific date or by an event which is not subject to the control of the donor/trustee/etc.; the sale of an unmarketable asset will qualify. The payment form changes as of the beginning of the year following the triggering event. This type of trust is often used with gifts of real estate, because no trust payments are required until the property is sold and the proceeds are re-invested.

2. Selection of Payout Rate. Charitable contribution deduction and cashflow projections need to be prepared and reviewed in order to select the optimal payout rate.

3. Designation of Charitable Remainder Beneficiary. You may want to name one or more charities, and possibly keep the right to change the charitable designation. In addition, you may restrict the use of your gift to a particular charitable purpose.

4. Other Trust Design Issues. There are other issues and alternatives involved in the design of the CRT document which need to be reviewed and addressed; such issues include the trustee and successor trustee designations, trustee removal and replacement procedures, alternate charitable remainderman designation, and accounting requirements.

5. Resolution of Technical Design Issues. Any technical issues need to be identified and resolved early in the process. Two such issues are:

(a) In order to avoid recognition of capital gain on the sale of the property, the IRS requires the CRT to be the bona fide seller of the property after it is transferred

to the CRT. You will be taxed on the capital gain if the trustee of the CRT can be compelled by the buyer to sell the property or is legally obligated to sell the property.

(b) Prior to transferring the property to the CRT, the property should generally be free of any debts or mortgages. If the property is not free of such encumbrances, the trust may be disqualified as a CRT. If there is a mortgage on the property, it is often advisable to satisfy it from cash assets or by borrowing against other assets.

B. Evaluation of Property. The proposed property should be reviewed to ensure it is an appropriate CRT asset. For example, issues to review regarding a gift of real estate include the title to the property, existence of mortgages or other encumbrances, likelihood of contamination, marketability, and the need for repairs.

III. DRAFTING. After the gift design is complete, I will prepare the CRT document, asset transfer documents, and any other required documents. Drafts will be sent to you for review.

IV. IMPLEMENTATION.

A. Execution of Documents. Once approved by all parties, the final CRT agreement must be executed. The trustee must also sign Schedule A to the trust, indicating receipt of the donated property. You must sign any required asset transfer documents.

B. Obtain an Appraisal. To obtain an income tax deduction for the charitable gift of property other than cash or publicly traded securities, you must obtain an appraisal and file Form 8283 with your Form 1040 for the tax year. The appraisal must be made by someone who is held out to the public as an appraiser, or performs such appraisals on a regular basis, and is willing to assume the responsibility of signing the Form 8283. The qualified appraiser may not be you, the charitable remainderman or a party to the transaction in which you acquired the property. The appraisal must be made within 60 days before the date of the transfer to the CRT or before the filing due date for your income tax return on which you take the deduction.

C. Move-Out. If an interest in real property is contributed to the trust, you must move-out of the property to avoid self-dealing.

D. Sale of Contributed Property. Often, the trustee of the CRT will move to sell the contributed property promptly. While the property is held by the CRT, the trustee must take any steps needed to maintain the property prior to sale. With respect to real estate, the trustee will need to pay expenses relating to the property (including maintenance, taxes, and insurance).

V. WORKING WITH THE TRUSTEE OR TRUST ADMINISTRATOR.

A. Getting a Tax ID Number. An IRS Form SS-4 must be filed to obtain a taxpayer identification number for the CRT.

B. Setting Trust Value. The trustee must value the assets contributed to the CRT. If you have selected a unitrust, the trust assets must be valued by the trustee every year to determine the correct unitrust amount to be paid.

C. Calculation of Payout. The trustee must calculate the amount due to the income beneficiaries, and ensure proper payments are made.

D. Annual Tax Returns. The trustee must insure that the proper returns are filed for the CRT. Every year, the CRT is required to file IRS Forms 5227 and 1041A, including Schedule K-1. In addition, the State of California requires the filing of Forms 541-A and 541-B.

E. Annual Trust Reports. In addition to tax reporting, the trustee of a CRT is generally required by state law to prepare an annual accounting of trust assets, receipts and expenses. This requirement may be modified by the terms of the trust.

F. Investment. Trust funds must be invested by the trustee, subject to the standard of care and prudent investor rules of California law.

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