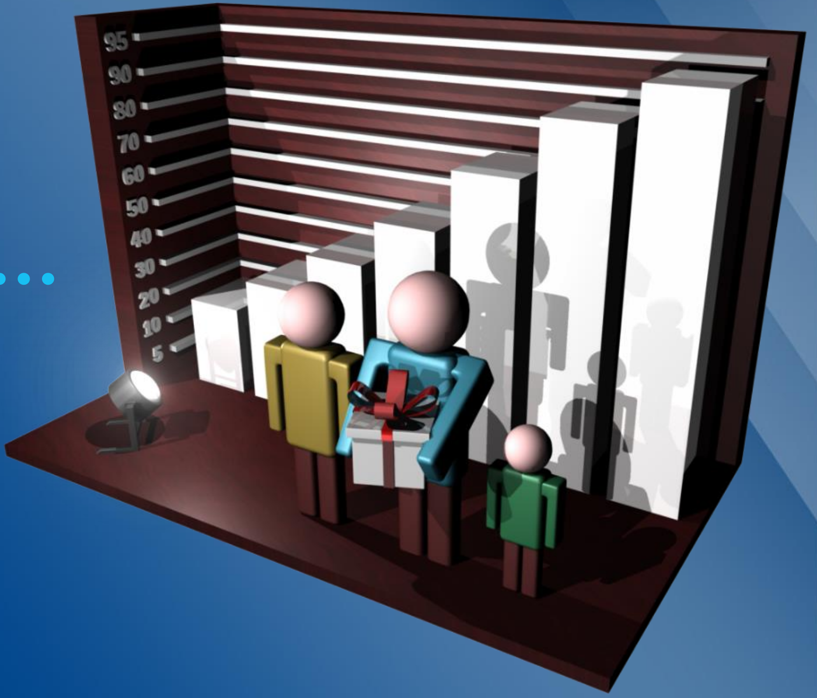
HOW Much Is ENOUGH?

Part I



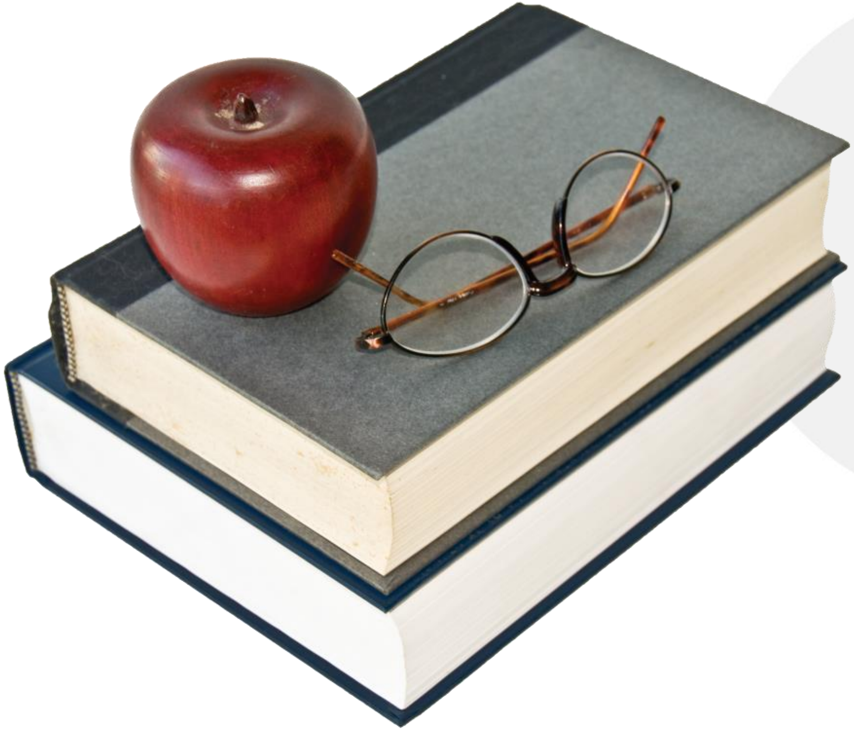
With **A. Charles Schultz, JD, AEP®**

Integrity and Initiative

- Primary Goal of Estate Planning
- Making the Child a “Better Person”
- How to Transfer?
- “Learning” and “Earning”

Time to Learn

1. Lifetime Gifts
2. Estate Principal
3. Income Stream
4. Deferred Principal



1. Lifetime Gifts

- What age to start?
- Age of financial responsibility
- Part or all of annual exclusion
- Gifts of property
- Gift of education

Gifts to Children

- Why Give?
- When to Give?
- What to Give?
- How to Give?
- Should you Give Different Amounts?
- The Effect on Self Esteem
- Gift of Education
- How to Transfer Values?

Why Give to Children?

Start Inheritance Process

Help with Home

Cost of Children

Offer Advice & Encouragement

When Should a Parent Give?

- Age of Financial Responsibility
- What is That Age?
- Resources of Parent
- Pensions, Social Security, IRA, Investments

What Should You Give?

- Gift of Cash – Age 30-50
- 8 of 10 Spent Cash Gifts
- 8 of 10 Spent other Earnings
- Best Gift – Property or Stocks
- Gift Exclusion ($16,000 in 2022)

Give Different Amounts?

Children	Different Economic Situations
Gifts	Viewed as Representing Love
Usually	Give Equally
Exception 1	Special Needs Trust
Exception 2	Family Business

Impact on Motivation

- Best Gift – Education
- Help Start a Business
- Wait for Maturity
- Gift of Stock or Land

Why Don’t They Think Like Us?

- Parents Would Invest the Property
- Children Are Different
- Children Need “Time to Learn”
- Parents Must Understand “Mistakes”
- Gifts Help Them Acquire Wisdom

How to Transfer Values

- Teach Values to Children
- Good Parenting from “Family”
- Provide for “Extended Family”
- Show Benefits of Helping Others
- Planned Gifts – Family & Extended Family

2. Estate Principal

- Bypass Trust
- Insurance Trust
- Living Lead Trust
- Bequest of Property

3. Income to Children

Opportunity to Learn to Invest

Term of Years Unitrust

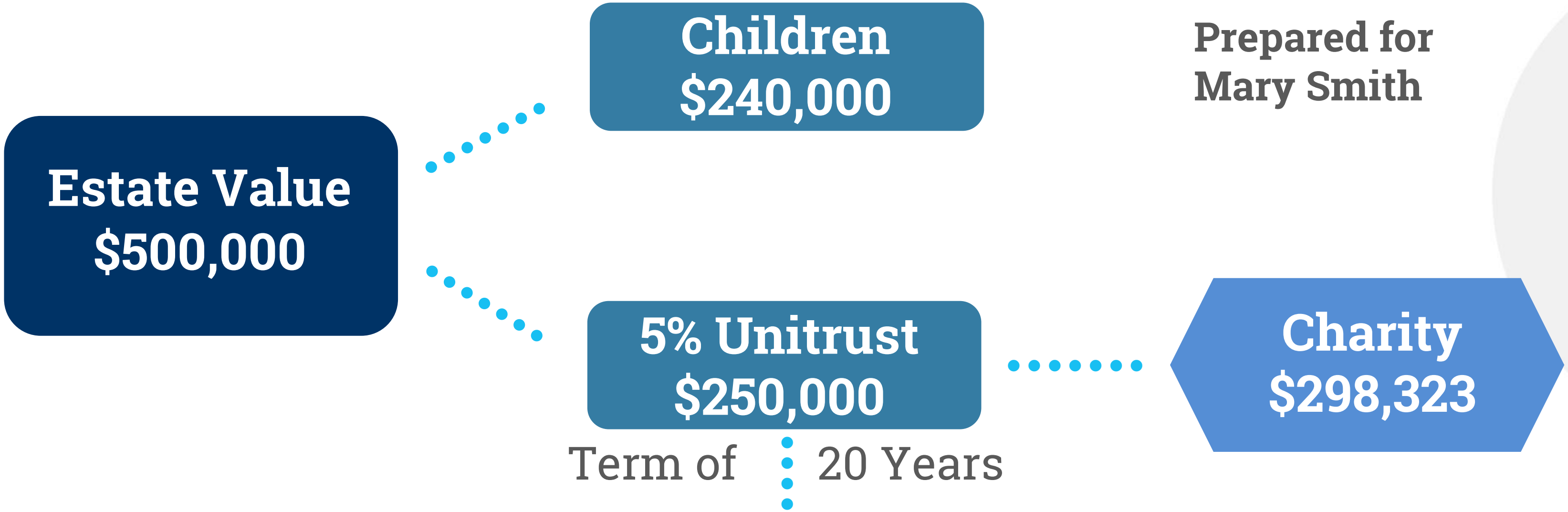
One-Life Unitrust

IRA or Pension Plan to Trust

Income to Family

Testamentary Unitrust

Prepared for
Mary Smith



1. Part of estate to unitrust with balance, after taxes and costs, to Children.

2. Trust income of 5% paid for 20 years. First year income $12,500. Total income $272,244.

3. After income payments for 20 years, unitrust to charity.

* GiftLaw Pro Ch. 6.7.5, Ch. 3.11.4

Testamentary Unitrust

Prepared for Martha Washington

Estate Value
$12,000,000

Children
$6,760,000

Charity
$1,000,000

5% Unitrust
$4,000,000

Term of 20 Years

Charity
$4,773,173

1. Part of estate to unitrust with balance, after taxes and costs, to Family. Charitable tax deductions of $2,443,492 may save estate taxes of $977,397.

2. Trust income of 5% paid for 20 years. First year income $200,000. Estimated total income of $4,355,906. Estate costs are $240,000 and taxes are $0.

3. If unitrust earns 5.89%, pays 5%, then grows 0.89%. After income payments for 20 years, unitrust to charity.

4. Deferred Principal

Trust Corpus Distribution

Charitable Lead Trust

Family

Charity

Major estate taxes saved

Potential growth to family

HOW Much Is ENOUGH?

Part II

With **A. Charles Schultz, JD, AEP®**

Jones Family

- **Father**
  Business owner & Family
- **Mother**
  Career & Family
- **Three children**
  On their way

Surviving Spouse

Home

Liquid Assets

Income
For Lifestyle

"Sleep Well"
Plan

Inheritance For Children

"Plan A" Provide Everything

"Plan B" Added Economic Security

Goals for Children I & I

"A good inheritance is designed to help a child to be a better person."

– Charles Schultz

Integrity

Initiative

Responsible Child Plan

- Receives love of parent
- No large checks
- Provides for own needs

How to Benefit Children

- Added retirement income
- Payout benefit for age 50+
- Inflation protection
- Modest investment risk

Potential Child Problems

- Divorce
- Lawsuit
- Poor investments
- Overspending income

Creative Spender

Cars

Boats

Child

Vacations

Solution for Each Child

Potential Growth
1% to 3%

5%
Unitrust

Personal
Foundation

Lifetime
Income

Flexible
Protection

How Much Added Lifestyle?

“What level of added lifestyle is the right plan for each child?”

Unitrust Value	Payout of 5%*
$500,000	$25,000
$1,000,000	$50,000
$1,500,000	$75,000
$2,000,000	$100,000

*Payout amount plus current income equals total income.

Legacy Gift Plan

Remainder to Charity or Foundation

Field of Interest Endowment

Donor Advised Fund

Supporting Organization

Enormous Satisfaction

- Parents build up estate
- Lifetime benefits for children
- Benefits for favorite nonprofits

Creating the Plan

- Think about needs & desires of children
- Establish "I & I" goals
- Learn about methods
- Develop plan with advisors
- Sign plan





HOW Much Is ENOUGH?

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How Much Is Enough?

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Integrity and Initiative

Pat and Allen were talking about their three children. They are empty nesters and the three children are off making their way in the world.

Pat: "I've been thinking about our three children. They are all doing fine, but we want to make sure that the inheritance we give them helps them to be better people. The inheritance some of our friends gave to their children was substantial, but the children just didn't use it very well. In fact, when an uncle of mine passed away, the inheritance was used very poorly by his children."

Allen: "But how do we make sure that the inheritance for our children leads to a good result? We need to do some research to make sure that our plan works effectively."

Pat and Allen did their homework. They read articles and spoke with several advisors, seeking wisdom. The result of their study is an inheritance plan that helps the child to be a better person. It is summarized as the "Integrity and Initiative" plan.

Goals of Parents

Your primary goal as a parent is to help each child be a successful person—not just financially, but also in his or her career, family life and social status. While attorneys and CPAs are trained to help you transfer property to children, a good inheritance plan is much more than just transferring property. As Pat noted, there are many plans that are successful in transferring property but lead to a very bad result.

Yes, a successful plan transfers property. But good planning transfers it at the right time, the right way and in the right amount so that it achieves a good result. While a good result cannot be guaranteed, the "Integrity and Initiative" plan will increase the probability of that favorable result.

Time to Learn

The first strategy of the Integrity and Initiative plan is to spread the resources out over time. This gives children some time to learn.

Parents have usually acquired an estate over 20, 30 or even 40 years. If you ask a person of retirement age to recall their early years, they will frequently share stories about the challenges they faced. For most people of retirement age, those challenges were financial "bumps in the road" that were very educational. Without that education, they would not have been as successful in life or in their finances.

Children who will receive a substantial inheritance also need time to learn. An inheritance can be stretched over a period of time. This may enhance the overall probability that the inheritance will facilitate development of integrity and initiative.

A good "Integrity and Initiative" plan could transfer property in four ways:

1. Gifts during life

2. Principal after the parents pass away

3.Income for a period of years

4. Delayed principal

Gifts During Life
When should a parent start making gifts to children? The easy answer is as soon as the children reach the age of financial responsibility.

But what is that age? That will vary, but most children in their 30s, 40s or 50s do reach that point of maturity.

At that time, parents frequently start by making gifts using the annual gift exclusion. This exclusion amount may be gifted with no tax or reporting to the IRS. The annual exclusion in 2022 is $16,000 per child and is adjusted every two to four years.

Generally, it is better to give property rather than cash. Cash tends to be spent fairly quickly. Regular gifts of cash may result in a child acquiring a taste for expensive items that are above his or her normal lifestyle. This can lead to problems later on in life.

By making gifts of stock, land or other types of property, parents encourage children to invest and build their assets. Therefore, a good gift is a gift of property.

Principal When the Parents Pass Away
The second gift strategy is to transfer principal after both parents pass away. This can be a bequest from the estate of the surviving spouse. The principal could also be a distribution from an insurance trust that pays to the children after both spouses have passed away. The transfer of principal could be a specific property such as a home, land or securities or it could be simply a portion of the estate.

Income For a Term of Years
A very popular third option is to create a trust that pays income for a period of 15 or 20 years to the children. For larger estates this is usually a charitable remainder unitrust. The trust is funded after both parents have passed away. It pays a 5% or 6% annual income to the children. In many cases, it is very advantageous to fund the trust with an IRA or other qualified plan. The trust

earns income for the family for the selected number of years. At the end of the 15 or 20 years, the trust is then transferred to favorite charities.

The combination of some principal and income for a term of years is very helpful. Parents can treat their children equally; however, there are some children who may require a longer period of time to mature in their financial management. The combination of principal and income for a period of years allows these children the time to learn better money-management skills.

Delayed Principal
The fourth option is an additional payment of principal when the children have become more mature. Following the expiration of the payouts for the unitrust term of years, an additional amount can be distributed. This frequently is done through the "Wait a While" trust. Your attorney may have another name for that trust—the charitable annuity lead trust.

For the term of years that the children were receiving unitrust income under the third part of the plan, the charities receive the payouts from the lead trust. After the unitrust income payments have been made to children and that trust terminates, the children receive their delayed principal distribution from the lead trust.

Keys to Successful Planning
A successful Integrity and Initiative plan is created by understanding the four transfer options and then setting goals. These goals will frequently include a target amount for the inheritance for the children at each level. In addition, it is useful to create a total inheritance target amount per child.

For example, one parent wanted the children to receive $50,000 each year in income. Because a unitrust funded with $1,000,000 paying a 5% payout produces $50,000, she decided to set up a unitrust of that amount for each child.

Over the 20 years, the trust paid more than $1,000,000 as income to each child with the remainder then distributed to charity.

Conclusion
Allen and Pat carefully thought through the four different options. They established the overall target inheritance number for each child. After learning about the different options, they decided to use the first three options. With a combination of gifts during life, some principal from an insurance trust when both parents pass away, plus income from a unitrust for a term of 20 years, they were able to achieve all of their objectives.

Pat concluded, "We now feel that we have a much better plan. We are not just transferring property to our children, but we have carefully thought through the ways in which the inheritance will help the children. With the combination of gifts during life, some principal, and then income for a term of 20 years, we are giving our children the best possible opportunity to develop integrity and initiative."

3.10.1 Unitrust Duration and Recipients

Unitrust Duration and Recipients

Duration: A charitable remainder unitrust (CRT) pays a fixed percentage for a life, lives, a term of up to 20 years, or a combination of a life or lives and a term up to 20 years.

Duration

A charitable remainder unitrust (CRT) pays a fixed percentage for a life, lives, a term of up to 20 years, or a combination of a life or lives and a term up to 20 years. Reg. 1.664-3(a)(5)(i). In most circumstances, the income is paid to the donor for one life or to donor and spouse for two lives. Alternatively, the unitrust amounts may be paid for a term of no more than 20 years, or for a combination.

It is also permissible to combine periods. The unitrust amounts may be paid for one or two lives, with a guaranteed number of years up to 20 years. In effect, this trust pays for the longer of the selected term of years or the two lives. If the life income beneficiaries pass away prior to the term of years, the balance of the term may be transferred to children, nephews, nieces or other family members. However, with a two life unitrust that includes a guaranteed term of years, a married couple does forego the marital deduction under Sec. 2056(b)(8) if one spouse passes away prior to the expiration of the specified term of years.

A trust also may be created for the lesser of a life or a term of years. For example, a trust may be created for a term of 20 years, but it will terminate if the income recipient passes away prior to that time and the remainder will be distributed to charity. This duration will result in a larger charitable deduction than a straight term of 20 years, since it is possible that the income recipient will pass away prior to the expiration of the term.

Finally, it is permissible to create a unitrust for one or two lives plus a term of years. However, this agreement is only permissible if all current and successor unitrust recipients are living at the inception of the trust, and the trust will terminate upon the earlier of the demise of all income recipients or the expiration of the term of years. In effect, the trust is created for one or two lives plus the lesser of the lives of the successor income recipients or the stated term of years. Reg. 1.664-3(a)(5)(ii).

Early Termination of a CRUT

It may be possible for a donor to terminate a CRT and cash out his or her interest. There have been several Private Letter Rulings that have allowed such a transaction. The termination may be by gift, sale, conversion to a gift annuity or a combination plan. Both federal and state laws apply to a CRT termination.

1. Gift of Income Interest - A donor may give his or her entire income interest to the remainder charities. The donor will receive a charitable deduction for a gift of a zero basis capital asset. This deduction is usable to 30% of adjusted gross income because it is an appreciated asset. If the donor has retained the right to change charities, he or she will also need to vest selected charities with the remainder and irrevocably relinquish the power to change charities. See PLR 200802024. The selected charities will own vested interests in both the income and remainder of the CRT and, under the doctrine of merger, may terminate the trust and distribute the assets. Under state law, there may need to be approval of the termination by a probate court.

Example 3.10.1A - Gift of Unitrust Income Interest

Joe and Mary had created a two life charitable remainder trust. Their estate had grown substantially and the donors did not require income from the trust. The trust document permitted them to select the charitable remainder recipient. They irrevocably selected Favorite Charity as the remainder recipient and also transferred their current and contingent income interests to Favorite Charity. They received a charitable deduction for the value of the income interest. As a capital gain-type gift, the deduction was limited to 30% of adjusted gross income, with a carry forward for five years. See PLR 9550026.

Example 3.10.6B Specimen Unitrust Income Interest Gift Language

Trustee

Organization

Address

City, State Zip Code

Re: Charitable Remainder Unitrust _______________

Dear Trustee:

We are currently the income recipients of a two life charitable remainder unitrust that was created on July 4, 2005 with trust grantors Joe and Mary Jones, 123 Main Street, Anytown, Illinois 00000 and initial trustee Charitable Organization, 456 Main Street, Anytown, Illinois 00000. The unitrust federal ID number is ___________________.

As life income recipients, we have retained the power under section _________________ of that trust document to add, remove or modify by name or percentage the qualified exempt charitable remainder recipients. We declare our intention through this signed and dated writing to modify the charitable remainder recipients by irrevocably designating all of our income and remainder interests, whether vested or contingent, to a qualified exempt charity and relinquishing all powers to change charitable remainder interests.

In order to make a charitable gift of this charitable remainder unitrust, I hereby irrevocably designate qualified exempt charity _____________________________, of City, State, as the recipient of 100% of both the income and remainder interests in unitrust number __________________.

The trustee is authorized to recognize that under the doctrine of merger of income and remainder interests, the named exempt charity now owns all interests in this remainder unitrust. Therefore, the trustee may distribute the trust principal to the named exempt charity. Under the law of the state of _____________, this merger of interests may require consent of all trust beneficiaries or order of a probate court.

I understand that this transfer to a charitable organization may qualify under IRC Sec. 170 provisions for a charitable income tax deduction for the present value of the gifted income interest. Sincerely yours,

______________________________ Date: _____________

Unitrust Income Recipient

2. Sale of Income Interest - A donor may sell his or her entire income interest to the remainder charities. The donor will not receive a charitable deduction, but may receive cash equal to his or her income interest. If the donor has retained the right to change charities, he or she will also need to vest selected charities with the remainder. The selected charities will own vested interests in both the income and remainder of the CRT and, under the doctrine of merger, may terminate the trust and distribute the assets. Under state law, there may need to be approval of the

termination by a probate court. With the sale option, the donor will report the full sale price as a capital gain. See PLR 200152018. Under Sec. 1001(e)(1), the basis in the income interest is zero.

3. Convert Income Interest to Gift Annuity - A donor may transfer his or her entire income interest to the remainder charity for a gift annuity. The donor will receive a partial charitable deduction and the right to the annuity for one life. If the donor has retained the right to change charities, he or she will also need to vest selected charities with the remainder. The selected charities will own vested interests in both the income and remainder of the CRT and, under the doctrine of merger, may terminate the trust and distribute the assets. The gift annuity value equal to the income interest will be transferred to the annuity reserve fund. The remainder value in the CRT is transferred to the issuing charity. Under state law, there may need to be approval of the termination by a probate court.

4. Combination Plan - A donor may combine a gift, sale or gift annuity for portions of the income interest. With the outright gift or gift annuity. The donor will receive a charitable deduction. If the donor has retained the right to change charities, he or she will also need to vest selected charities with the remainder. Under state law, there may need to be approval of the termination by a probate court.

5. Valuation of Income Interest - With a sale if the income interest, the donor is not making a charitable gift and the applicable federal rate (AFR) used for the calculation must be the rate that corresponds with the date the donor decides to terminate the trust. With a gift of the income interest or conversion to a gift annuity, one of the prior two-month's rates may be used. For a net income plus makeup trust, the income interest is based upon the lesser of the AFR or the unitrust percentage. For a standard unitrust, the income interest is calculated using the unitrust payout percentage. All life income interest calculations require a determination that the income beneficiaries have normal life expectancies. If there are health issues, in order to use the Sec. 7520 mortality tables there should be a written opinion by a medical doctor that a reasonable expectancy exists (at least over the 18 month Reg. 25.7520-3(b)(3) presumption). See PLR 200552015.

6. State Law - Modification of an irrevocable trust is controlled by state law. A step that may need to be taken in terminating a charitable remainder trust early is to petition the probate court of the state under which the trust is formed. In California and other states, an alternative may be to terminate with consents from all income and remainder beneficiaries. One other recommended step in terminating a charitable remainder trust early is to notify the state attorney general of the early termination. The state attorney general in most jurisdictions oversees all charitable trusts.

Permissible Recipients

Normally, the donor is the income recipient for a one-life unitrust, or a donor and spouse for a two-life trust. However, it is permissible to create a trust for another person or persons. Common CRT alternatives include those for a donor and child, nephew, niece or other relative.

If a unitrust is for a term of years, then it is permissible to name a class of individuals. Reg. 1.664-3(a)(3)(i). For example, a donor could create a charitable remainder trust with the income distributed among grandchildren. It is also permissible to grant the trustee the power to "sprinkle" among the grandchildren, so long as there is an independent trustee under Sec. 674(c). Rev. Rul. 77-285.

A charity is also a permissible recipient. The charity may receive a substantial proportion of the income, so long as the non-charitable income recipient receives at least a "de minimus" amount.

Another option is for a trust to be the beneficiary of a payment from a term of years charitable remainder trust. However, if the unitrust is a one-life trust, then payments to a second trust are deemed permissible only if the single beneficiary is incompetent. PLR 9718030.

Special Rules for Fixed Percentage Trusts Created Before December 10, 1998

The payout from a unitrust may be made within a reasonable time after the close of the calendar year, if the unitrust amount is 15% or less of initial net fair market value. Reg. 1.664-3(a)(1)(i)(h). However, if the payout exceeds 15%, with a standard or type I unitrust the payout must either be made prior to year end or the trustee must elect to treat the payment as though it had been made by December 31.

Qualified Contingency

The duration of a charitable remainder trust may be shortened by a qualified contingency. Sec. 664(f). It is permissible to shorten the duration of the trust based on an objective event, such as marriage, divorce or a similarly defined event. If the specified event takes place, then the trust may be terminated and the remainder transferred at that time to charity. Since the event is generally contingent, there is no increase in the income tax deduction, regardless of the nature of the event.

"Special Needs Trust"

Charitable remainder trusts may be drafted for a life, lives or a term of years. However, if a beneficiary is subject to a disability, then it may be desirable for the trust to have discretionary payment options. Thus, some grantors have preferred to create a charitable remainder trust that makes distributions to a second trust. The second trust is usually described as a "special needs trust" and permits discretionary distributions for the support and care of an individual with a financial, physical or mental disability.

In Rev. Rul. 2002-20; 2002-17 IRB 794 (29 Apr 2002), the Service set forth guidelines for charitable remainder trusts that make payments to special needs trusts. First, if the charitable remainder trust is for a term of twenty years or less, then it may make distribution to a special needs trust. However, if the charitable remainder trust is payable for a lifetime, then it should meet several requirements. First, the trust must be for one lifetime and the beneficiary must be under a disability that renders him or her unable to manage personal financial affairs, as defined in Sec. 6511(b)(2)(A). Second, special needs trust should follow one of three formats:

I. Flow Through Trust. "The trust may be a "Flow Through Trust," in which the unitrust payouts are made to the special needs trust and then are distributed to the beneficiary. Additional distributions may be made under a trustee discretionary power. The remainder will be distributed to the income recipient's estate.

II. Discretionary Trust. Alternatively, the special need trust may have a discretionary payment provision, which permits the trustee to make payments that would not supplant governmental benefits otherwise available. With a discretionary special needs trust, the remainder of the trust is payable to the estate of the special needs person.

III. Discretionary with Power of Appointment Trust. Finally, a discretionary trust may be created with the income recipient holding a testamentary general power of appointment. If the special needs person does not exercise the general power when he or she passes away, then the remainder may be distributed to family or to charity.

Since unitrust payments may be made for the benefit of, rather than to an income recipient, the unitrust may make payments to a special needs trust because the payments are, in effect, received by the special needs person. The above options are also available for an annuity trust.

In addition, it is possible for gift annuity payments to fund a special needs trust. While the gift annuity provides for fixed payments over the life of the person with special needs, distributions from the gift annuity to the trust must be limited and based on special needs. To avoid disqualifying the individual from receiving government aide, it is best to permit distributions to the trust at the discretion of a special trustee knowledgeable of the federal requirements.

3.8% Net Investment Income Tax

In the Healthcare and Education Reconciliation Act of 2010, a 3.8% tax on net investment income (NII) was passed. The tax applies generally for married couples with income over $250,000 and for other persons with income over $200,000. Purely charitable trusts and pooled income funds are excluded from the tax. However, distributions from Sec. 664 charitable remainder annuity trusts and unitrusts (individually a "CRT") may be subject to tax.

On November 26, 2013 the IRS published comprehensive final (T.D. 9644) and proposed (REG 130843-13) regulations on net investment income (NII). The final and proposed regulations reflect the complexity of the entire tax code. As CPAs face the daunting task of filing tax returns for 2013, they will be forced to deal with extensive technical rules on NII.

The regulations addressed multiple key issues. Many individuals and entities rent property from themselves. Real estate professionals are engaged in an active trade or business. Investors in various securities have both net losses and gains. A disposition of a partnership interest can raise substantial issues.

The final regulations set forth many technical rules to cover these situations. The proposed regulations also offer an optional simplified method to calculate distributions from passive entities. There are five specific sections that apply to charitable interests.

Charitable Gift Annuities - Commentators had proposed that payments from annuities funded prior to 2013 should be partially exempt from NII. The IRS determined that NII would apply in full to the ordinary and capital gain elements of gift annuity payouts.

Pooled Income Funds - The pooled income fund is subject to tax on short-term capital gains. There is a set aside for the long-term capital gain and the ordinary income is distributed and therefore deductible. However, pooled income funds are subject to taxation on short-term capital gains that are not distributed. That short-term gain will not be excluded from NII.

Charitable Remainder Trusts - CRTs are subject to the specific rules on accumulated net investment income (ANII). The charitable trust itself is not subject to payment of the NII. Proposed Reg. 1.1411-3(c)(2)(iii) defined ANII as "the total amount of net investment income received by a CRT for all taxable years beginning after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years beginning after December 31, 2012." This created an aggregate accounting rule that would exist in addition to the Sec. 664 four-tier accounting system. The final regulations responded to opinions by commentators that it would be preferable to track ANII within each tier. The final regulations provide specific examples for tracking the exempt and taxable portions of ANII within the four tiers under Sec. 664. However, the proposed regulations also indicate that the simplified method may be elected by the trustee rather than the four tier tracking system. The IRS reserves the right to remove this option for the simplified method in the future.

Charitable Purpose Trusts - If a trust is completely "devoted to one or more of the purposes described in Sec. 170(c)(2)(B)," then it is excluded from NII.

Charitable Purpose Estates - Some estates have distributed all non-charitable assets and are solely devoted to charitable purposes. If an estate is one in which "all of the unexpired interests are devoted to one or more of the purposes described in Sec. 170(c)(2)(B)," then it also is excluded from NII.

The very extensive and technical regulations concerning NII reflect the complexity of the Internal Revenue code. Unitrust CPAs will determine what items qualify as passive and are taxable and what items are excluded. With respect to charitable remainder trusts, each level of the four-tier system may also include both qualified and exempt accounting amounts for net investment income.

Case Studies on Unitrust Duration and Recipients

Death and Taxes - The Madison Era of Giving, Part 2 of 7: Still on an emotional high from his multi-million dollar gift toward the construction of a state-of-the-art library (see last week's Case Study), George Madison, Jr. has a new focus in his life - making a difference in children's lives. After making the gift to the school, George had a life-changing realization. George spent his entire life building up his business and accumulating his fortune and rarely gave of his time or money to others. Like many people, George's career and family were his number one priorities. Now nearing the latter part of his life, George feels a strong urgency to do things differently. Knowing the importance education played in his success, George strongly desires to set up gifts that would provide educational opportunities for underprivileged children. In addition, he would like to take full advantage of the tax benefits of making such a gift. While he is becoming more generous as of late, George has no interest in increasing his cash "donations" to Uncle Sam.

Death and Taxes - The Madison Era of Giving, Part 3 of 7:   George Madison, Jr., has definitely become a gift-making machine. Just in the past three months he has gifted $5 million to public charities. George's "ease" into retirement is turning out to be much more exciting than he had ever imagined. Due to the publicity of his two large charitable contributions, George has risen to the top of many gift planners' "people to call upon" list. One such list belongs to Eleanor Jacob, director of development at Education is Power schools. Eleanor consequently called George and asked if she could visit with him. After several visits and trips to the schools, George and Eleanor developed a good relationship. George liked the school's mission and felt he could contribute greatly to its further development. Therefore, George happily pledged a gift of $1 million to help Education is Power upgrade its classrooms and purchase new books for its students.

Unraveling the Life Plus Term CRT: Quintana, Arizona is the official yarn capital of the world. The city of Quintana in fact produces over 70% of all the yarn sold worldwide. There are six major yarn companies in Quintana with Spun, Inc. being the largest. Spun, Inc. is a family-run business headed by founders David and Mary Kabril. David, 69, and Mary, 68, have lived their entire lives in Quintana and plan to retire their as well. They truly loved the Quintana community and have raised all of their four children there. Not surprisingly, they strongly support the community with their time and charitable contributions.

The Prearranged "Stock Holder" Sale: Ken Barker, 65, was a senior level manager for a highly successful mid-sized company. After 35 years of employment with the same company, Ken retired three months ago.

Getting Back to the "Art of the Matter," Part 5:   Paulo Frambini, 45, is a talented artist and a self-proclaimed leader of the art purist movement. He lives, breathes and eats art history and culture. Paulo refuses to be characterized as any one particular type of artist. Accordingly, Paulo's artistic creations are very diverse and varied.

The Gift of Philanthropy to Two Sons: Lorraine Moore, a widow age 75, has an estate valued at $1 million. Her estate consists of her home valued at $100,000, liquid investments of $400,000 (primarily bonds and stock) and an apartment building valued at $500,000.

Economics vs. Charitable Intent... A High Payout Trust is the Solution: Sam Crawford, age 65, started a parts supply business over thirty years ago and with hard work and entrepreneurial expertise has built the company to a value of $5,000,000. Sam never married, has one brother and sister and would like to retire this year. The business is structured as a C corporation and five key employees have expressed an interest in purchasing 100% of the stock of the company. Both Sam and the employees feel that the $5 million value is a very fair price and would like to begin serious deliberations to purchase the company within the next 12 to 18 months. However, at this point, there has been no formal offer by the employees - only discussions "around the lunch table."

Should a CRT be Funded with an Installment Note?:   Gayle Goodman sold 10 acres of real estate she had owned for a number of years on an installment sale. The total sales price for the property was $500,000. She received $50,000 down and carried the balance of the purchase price on a 10% note amortized over a period of 25 years with a balloon payment due at the end of five years. Gayle had originally purchased the property for $100,000 and, therefore, will ultimately be required to report a gain of $400,000 on the sale of the property. Four-and-a-half years ago, when she sold the property, she reported a gain of $40,000 as a result of receiving a 10% down payment upon sale of the property. Since then she has reported another $10,000 of gain as a result of receiving principal payments on the note. Therefore, $350,000 of gain still remains to be reported on her tax return.

A FLIP for the Spouse: Michael Williams just turned 72 and has begun the mandatory withdrawals from his individual retirement account. The assets of the IRA have been invested primarily in equities over the past ten years and Michael has been astounded by the growth of the account over that period. What was once a very moderate account has grown to over $3 million in value and, therefore, he will be required to withdraw over $100,000 per year based on his life expectancy. Michael has planned to leave the balance of the account to charity upon his death, but he has become concerned about providing for Michelle. They do have $3 million in other assets, but the majority of the $3 million is in income-producing real estate which he manages. The real estate throws off a very nice income stream (over $200,000 net per year), but this is primarily because of Michael's management expertise. Michael is very concerned that should he predecease his spouse, the real estate will not produce near this kind of income because he will not be available to provide the savvy management skills.

Gift of Philanthropy to Two Sons: Lorraine Moore, a widow age 75, has an estate valued at $1 million. Her estate consists of her home valued at $100,000, liquid investments of $400,000 consisting primarily of bonds and some stock and an apartment building valued at $500,000. As a former high school history teacher, she lives comfortably with her pension and the income from her investments. The apartment building generates an income stream of about $20,000 per year after expenses.

A CRT as the Guarantor of a Charity's Loan: Jennifer Lange, age 65, is a retired stockbroker who has remained active in the markets ever since her retirement five years ago. She never married and has one surviving brother who now is 75 years of age. Apart from her brother and his two children, she has no immediate heirs. Jennifer has been very successful in her investing, having purchased stock in a number of computer and chip companies in the late 1980s. Her strategy to buy and hold has yielded great dividends, as she has seen an original portfolio of $250,000 balloon to $1,000,000. Apart from this portfolio of computer stock, she has another $500,000 in much more conservative balanced mutual funds.

A Like-kind Exchange with Debt-encumbered Property: Robert Boone purchased a rental house in 1990 for $100,000. As a result of depreciation on the property, his depreciated cost basis is $65,000 and the property, until recently, was free and clear. The real estate market has done very well in his locality and the property has appreciated in value to $250,000. However, to help fund a Grandchild's education, he secured a personal credit line with First National Bank using the property as security. The current balance on the line of credit is $10,000.

The Ultimate Donor Advised Fund: Juan and Maria Hernandez, ages 65 and 60 respectively, are successful produce farmers and own 200 acres of prime land on the outskirts of their local community. The land is currently being farmed and produces primarily a variety of fruits and vegetables.

First National Bank of the CRT: Eugene and Caroline Butler, both age 84, funded a charitable remainder unitrust back in the mid 1980's with $250,000 of highly appreciated real estate. Because of the illiquid nature of the property, a net income with makeup unitrust (NIMCRUT) was selected. They chose an 8% trust distribution percentage which was a reasonable payout rate based upon interest rates at that time. Therefore, the trust was written so that they would receive the lesser of net income or 8% of the fair market value of the trust as valued annually. No provision was drafted into the unitrust document to allow for distributions of capital gains as income since this creative concept was not yet being discussed in planned giving circles.

A Charitable Gift or AGI Limitations... Which is more Important?:   Marvin McLaughlin recently received a planned giving mailing from a college in Illinois which he has supported for a number of years. The mailing caught his eye because the primary thrust of the piece was a discussion on the benefits of charitable remainder trusts. Since he had some appreciated real estate, he decided to send in the response card with the question - "Do you ever get to San Diego?" Upon receiving the card, the charity contacted Marvin by phone and asked him if he wouldn't mind answering some questions since the only information in the charity's database on Marvin was his name, address and his giving record (which indicated contributions of $1000 per year for the past ten years). Marvin stated that he was 75 years old, married and was interested in "that charitable trust idea" discussed in the latest mailing. The funding asset would be a 32-unit apartment building located in central San Diego worth about $2.5 million. The charity was very excited about the prospects of a charitable trust and told Marvin that "Yes, they do get to San Diego." A trip was scheduled expeditiously by the Major Gifts Officer.

A Guardianship CRT: Franklin Roth is Sr. Vice President of a Major National Bank ("Bank"). The bank is currently acting in two fiduciary capacities with respect to Johnny Persons, who has been adjudicated mentally incompetent by the courts. First, the Bank is guardian of Johnny's estate. Second, the bank serves as trustee of an irrevocable trust (IRT) created for Johnny's benefit. The IRT was created by a decree of the Court ten years ago and was funded with cash from a substantial insurance settlement. Johnny suffered serious head injuries when he and his wife were hit head-on by a drunk driver which left him in an incompetent state. This trust was intended to protect Johnny's assets and ensure that they are used for his benefit. Johnny's wife was tragically killed in the accident.

Maximum Meatpacking LP Unitrust: Mother and Father were in business for many years and operated a meat packing plant. The plant was on the outskirts of a major urban area and they operated the plant successfully for 30 years. However, after Father passed away, the business began to decline and Mother sold all of the assets to another company. The plant was leased to another business for a number of years, but that business has now also moved to a new facility.

The Flexible Foundation: Jane and Bill Wilson are both 70 and are now retired. Years ago, they each inherited stock from their parents. The entire portfolio is now invested in two stocks. There has been no management of the portfolio for the past 30 years. Jane and Bill think that it would be good judgement to diversify. However they do not want to pay any capital gains tax. Both of them live fairly modestly and they will soon be required to start taking distributions from their IRAs. Thus, they do not want added income now, but may need more income in the future. Is there a way that Jane and Bill can diversify without paying tax? Can they control their income? If they need income, they would like to take income. If not, they would consider making gifts to charity. Can this arrangement be done at very modest cost?

3.10.2 Four-Tier Accounting

Four-Tier Accounting

CRT Payouts

Unitrust payouts are one of the most important areas for the advisor to communicate to the recipient. With a charitable remainder trust, the basic payout rule is that the unitrust percentage is multiplied times the trust value and that amount is then distributed. The distribution may be monthly, quarterly, semiannually or annually.

This distribution sounds reasonably simple. However, the options and the accounting can be fairly complex. The challenge for the advisor is to explain these rather complex options and concepts in simple terms to donors and clients.

Four-Tier Accounting

Approximately 80-90% of the CRTs in the future will be straight unitrusts or FLIP unitrusts that become straight unitrusts. This is, in part, because of ease of understanding and administration, but also due to the desire of donors to receive capital gain payouts.

Unitrust distribution rules are set forth in Reg. 1.664-1(b). Distributions from unitrusts are first ordinary income, then capital gain, then tax-free income and finally corpus. The distribution method is commonly described as the "Four-Tier" structure. In truth, the distribution rules have been made somewhat more complex by the different capital gains rules. The capital gain tier is further subdivided into the four levels for capital gain. The actual final structure is as follows:

Category	Tax Rate
Ordinary Income	37%
- Dividends	15%/20%/23.8%
Capital Gain -	
- Short-Term Gain	37%/40.8%
- Tangible Personalty Gain	28%
- Depreciation Gain	25%
- Long-Term Gain	15%/20%/23.8%

Tax-Free	0%
Return of Principal	0%

The process and accounting can be complex, but the concept is simple. The distribution to the recipient will require payment of tax at the highest possible rate. Thus, all ordinary income earned by the trust must be distributed before any capital gain is paid out.

Since the goal for most trusts is to distribute capital gain, the trust investments are carefully selected to minimize production of ordinary income and maximize recognized capital gain. Of course, creation of capital gain return involves inherent risk-return issues that will be addressed in subsequent chapters.

Case Studies on Four-Tier Accounting

In-Kind Distributions to Donors, Part 1 of 2:   Jim Thompson, a retired engineer, and his spouse Logan Thompson, a retired nurse, are currently considering funding a term-of-years charitable remainder unitrust with Americans for the Arts charity. Americans for the Arts is raising money for the construction of a new building which would house a state-of-the-art theatre and museum. The Thompsons, while retired, are active investors and have amassed quite a fortune over the past few years. In particular, they have investments in numerous established technology companies that have quadrupled in value over the past two years. They would like to use $800,000 of stocks with a cost basis of $100,000 to fund a five-year CRUT with a 15% payout. However, they believe these companies are great investments with acceptable risk and prefer that the trustee of the CRUT not sell these stocks. Furthermore, the Thompsons would like their CRUT payouts to be the actual stock - an in-kind distribution - as opposed to cash payouts. Thinking creatively, the Thompsons then wonder if such a distribution would avoid capital gain since technically the stock has never been sold.

In-Kind Distributions to Charity and the Reverse Four-Tier, Part 2 of 2:   Jim Thompson, a retired engineer, and his spouse Logan Thompson, a retired nurse, are currently considering funding a term-of-years charitable remainder unitrust with Americans for the Arts charity. Americans for the Arts is raising money for the construction of a new building that would house a state-of-the-art theater and museum.

Stock Unitrust Payouts to Donors: Jim Thompson, a retired engineer, and his wife Janet Thompson, a retired nurse, are currently considering funding a term charitable remainder unitrust with the Americans for the Arts charity. Americans for the Arts is raising money for the construction of a new building which would house a state-of-the-art theatre and museum.

3.10.4 Types of Unitrust Payouts

Types of Unitrust Payouts

Optimum CRT Payouts

Payouts are among the most important areas for the advisor to communicate to the recipient. With a charitable remainder unitrust, the basic payout rule is that the unitrust percentage is multiplied times the trust value and that amount is then distributed. The distribution may be monthly, quarterly, semiannually or annually.

This distribution sounds reasonably simple. However, the options and the accounting can be fairly complex. The challenge for the advisor is to explain these rather complex options and concepts in simple terms to donors and clients.

There are four principal formulas for payments of unitrust amounts. An attorney drafting unitrust documents must understand clearly the four different methods, the appropriate language for each method and the correct use of each of the four options. The four options are commonly referred to as "Type I - Standard Unitrust (Reg. 1.664-3(a)(1)(i)(a)), Type II - Net Income Plus Makeup Trust or NIMCRUT, (Reg. 1.664-3(a)(1)(i)(b)(2)), Type III - Net Income Only Unitrust (Reg. 1.664-3(a)(1)(i)(b)(1)), and Type IV - FLIP Unitrust (Reg. 1.664-3(a)(1)(i)(c))."

Type I or Standard Unitrust

The Type I or Standard Unitrust is reasonably straightforward. In the vast majority of cases, the valuation date for the trust is January 1 of each year. The selected unitrust percentage is multiplied times the value of the trust and that is the annual amount. If the amount is paid semiannually, quarterly or monthly, the unitrust amount is divided by two, four or twelve to calculate the distributions.

This plan has several advantages. It is fairly easy for the donor to understand, it is quite easy for the CPA or attorney to explain to the client, and it is fairly easy to distribute capital gain. For these reasons, the standard unitrust is preferred by donors, trustees and the Internal Revenue Service. While the IRS does not publicly advocate specific trust types, the standard unitrust is logically preferable, since it increases the probability of compliance by trust administrators. The standard unitrust is commonly used when public stocks or other liquid assets are transferred to a CRT.

Type II or Net Plus Makeup Unitrust (NIMCRUT)

The Type II or Net Income Plus Makeup Trust pays the lesser of trust income or the unitrust percentage. A NIMCRUT was initially included in the 1969 legislation because donors often contribute real property to charitable trusts. The real property may not earn sufficient income to enable the trustee to make the required payment. Thus, the trust may pay the lesser of the unitrust amount or the actual income earned until the real property is sold. After the real property has been sold and the proceeds reinvested, the trust will pay the regular unitrust amount. If there are excess earnings over the unitrust amount, any shortfall or deficit in the initial years could be repaid. The latter amount is referred to as the "makeup" portion of the payout.

This method has become quite popular for those donors who desire an "income control" unitrust. Through careful selection of either growth or income assets, the trustee may allow growth for a period of time, such as prime earning years prior to retirement. After retirement, the trustee could shift from a growth to an income-producing investment and then make distributions of both the regular unitrust amount plus the makeup amount.

Under Reg. 1.664-3(a)(1), income is defined under Sec. 643(b) and the applicable regulations. Reg. 1.643(b)-1 notes that income shall be defined under the "governing instrument and applicable local law."

In states that have passed the Uniform Principal and Income Act, a trustee of many trusts may be given the power to allocate capital gains to distributable income or to principal. However, a charitable remainder unitrust under Reg. 1.664-3(a)(1)(i)(b)(3) is precluded from permitting the trustee to have a purely discretionary power to allocate capital gain. The unitrust drafter may allocate all recognized capital gain to income, no recognized capital gain to income or a fixed fractional part of gain to income. An alternative to permit discretionary distribution of capital gain is to place the unitrust assets in a partnership or single-member LLC. When a trust payout is desired, recognized capital gains are distributed from the partnership or LLC to the unitrust, and then to the income recipients.

There also is a limit on recognized capital gain allocated to income with a NIMCRUT. Under Reg. 1.664-3(a)(1)(i)(b)(3), the pre-gift gain must be allocated to corpus. Only post-gift capital gain may be allocated to income and distributed to income recipients.

Type III or Net Income Only Unitrust

The Type III or net income only trust is very similar to the Type II trust, except there is no makeup provision. Once again, the trust pays the lesser of the income or the unitrust percentage. This formula is used infrequently. Generally, it is helpful for individuals who desire income, but want to ensure a substantial remainder to the charity.

Type IV or FLIP Unitrust

The Type IV or FLIP unitrust was created by regulations. In Reg. 1.664-3(a)(1)(i)(c), the Service permits a trust to function initially as a Type II or Type III trust. After a "trigger event," the trust will change the following January 1 to a Type I or standard unitrust. The triggering event may be a sale of unmarketable assets, marriage, divorce, death or birth of a child.

With a FLIP, any existing deficit is forfeited when the trust changes to a Type I unitrust on the January 1 after the trigger event. If there has been appreciation of the assets prior to the trigger event, then an initial NIMCRUT formula with recognized capital gain allocated to income could permit repayment of part or all of the makeup account. However, in most cases it may be preferable to retain the gain tax-free in the trust and benefit from added income for life, rather than distributing the makeup in one year and paying the tax in one year.

Generally, the FLIP unitrust is used for sale of unmarketable assets. Nearly all unitrust drafters will now use a FLIP unitrust rather than a NIMCRUT for real property. The real property is transferred into the FLIP unitrust, sold during the first year and the trust subsequently FLIPs to a straight unitrust.

Case Studies on Types of Unitrust Payouts

Michael "FLIP's" for Spouse: Michael Williams just turned 70 ½ and has begun the mandatory withdrawals from his individual retirement account. The assets of the IRA have been invested primarily in equities over the past ten years and Michael has been pleased with the growth of the account over that period. What was once a very moderate account has grown to over $1.5 million in value and, therefore, he will be required to withdraw over $100,000 per year based on his life expectancy. He plans to leave the balance of the account to charity upon his death, but he has become concerned about providing for his spouse when he is gone. They do have $3 million in other assets, but the majority of the $3 million is in income-producing real estate which he manages. The real estate produces a very nice income stream (over $200,000 net per year), but this is primarily because of Michael's management expertise. He is very concerned that should he predecease his spouse that the real estate will not produce near this kind of income because he will not be available to provide the savvy management skills.

Three Thousand Shares of Stock, Two Possible Trigger Dates, and One FLIP: Sarah Stevens, a 42 year-old CEO and MBA graduate, has managed to build a very successful technology company from scratch. Over the past ten years, her closely held company has grown exponentially. In order for it to maintain this incredible growth, Sarah decided many months ago to take the company public this December. Based upon its business model and current success, Sarah's company is expected to be a "hot" IPO. Sarah also knows that despite her company being worth a great deal, she will continue to receive a lower income until the company can start to turn larger profits. In fact, during the past several years, Sarah has paid herself only a moderate salary as she poured money back into her company.

FLIP Unitrust v. NIMCRUT - And the Winner is ...:   Samantha and Kevin Donaldson, both 55, have been married for over thirty years. They are professional musicians and have been members of the city orchestra for twenty years now. Not surprisingly, Samantha and Kevin are passionate supporters of music. They hold workshops to teach young people musical instruments, and can be frequently found passing out flyers to encourage attendance at the city orchestra's performances. In a recent visit with the orchestra's gift planner, Jamie Evans, the Donaldsons indicated their desire to leave a gift to the orchestra upon their death. The Donaldsons estate was valued at $2 million, and they envisioned a bequest of $200,000. Jamie then described the benefits of a Charitable Remainder Trust (i.e. tax deduction now, bypass of gain, increase income) and suggested it as an option. The Donaldsons loved the idea they could receive an income tax deduction now for a gift they planned to make in the future. Furthermore, they had a large block of appreciated assets that would be well suited for the CRT. The only reservation the Donaldsons had was the increased income. They were currently in their highest income earning years, and did not need to boost their taxable income. Preferably, the Donaldsons would like to defer the income until they retire. Therefore, they ask Jamie if there was a way to structure the CRT to act like a retirement vehicle. Jamie recalls a session she attended that discussed the use of FLIP Unitrusts and NIMCRUTs as retirement vehicles, however, she was unsure which CRT was more appropriate in the Donaldsons situation. Which CRT should the Donaldsons utilize for their situation, a FLIP Unitrust or a NIMCRUT?

Exit Strategies for Real Estate Investors, Part 2:   Karl Hendricks was a man with the golden touch. Throughout his life, it seemed every investment idea that he touched turned to gold. By far, Karl was most successful with real estate investments. It was definitely his passion.

Exit Strategies for Real Estate Investors, Part 14: Karl Hendricks was a man with the golden touch. Throughout his life, it seemed every investment idea that he touched turned to gold. By far, Karl was most successful with real estate investments. It was definitely his passion.

Lucky Lucy Lindstrom's Unitrust: Lucky Lucy Lindstrom finished college and headed west. She started as a financial analyst with a large company in Seattle. After just four years, she became a Registered Investment Advisor and began advising clients.

Turning a Farm into a "Field of Dreams": Duane and Ruth Bradley, both age 65, have farmed their homestead for the past 35 years. Ruth inherited this land consisting of 85 acres from her grandfather in the late 1950s. At the time of the inheritance, the acreage was valued at only $100 per acre and therefore, the basis in the property is only $8,500. Over the last ten years, the local community has experienced substantial development and now the property is located right on the outskirts of town. The property in the area is now selling for $12,500 per acre and therefore, the fair market value of their land is currently over $1 million. Duane and Ruth have been planning to use the property for their retirement as they have been unable to put any substantial sums aside over the years for this purpose. They have sacrificed greatly to put each of their five children through college and now must think about their retirement. Fortunately, the land has appreciated greatly over the last few years and they can now look to the property to provide a comfortable retirement.

Still Time To FLIP?: Jake and Kristine McCarthy, both age 75, created a two-life plus 15-year term net income with makeup charitable remainder unitrust (NIMCRUT) about 10 years ago. They chose a payout rate of 5% and funded the trust with $500,000 of highly appreciated stock. Since Jake was a keen stock investor (and since he liked to keep control of their investments) he decided to self-trustee the unitrust. Since they really did not need the income from the trust, Jake made the decision to invest 100% of the trust assets in an aggressive portfolio consisting of stocks and mutual funds. Periodically, he would buy and sell but, for the most part, he followed a buy-and-hold strategy. Over the years, the dividend yield on these investments has averaged 2% and the capital growth yield has averaged about 10% for a total return of 12%. Because of Jake's investment strategy, the trust has grown to over $1.2 million and the deficit account is now about $250,000.

3.10.9 Income, Gift, Estate and Generation-Skipping Transfer Taxes

Income, Gift, Estate and Generation-Skipping Transfer Taxes

Income Taxation

The donor to a charitable remainder unitrust will receive an income tax deduction equal to the present value of the remainder interest. It is calculated using the applicable federal rate for the current month or one of the prior two months, as permitted under Sec. 7520.

The unitrust payouts will be taxed to the recipient under the four-tier taxation structure. Sec. 664(c)). Payments will be first ordinary income, then capital gain, then tax exempt or other income and finally return of principal.

A charitable remainder unitrust is irrevocably dedicated to charity, and therefore is normally exempt from income tax. However, if the trust has acquisition indebtedness or engages in business that is regularly carried on, the trust will recognize unrelated business income. Sec. 512. Sec. 514. See also Newhall v. Commissioner.

With assets from an active trade or business in the charitable remainder trust, there will be tax on the UBI. The trust will be subject to 100% excise tax on the unrelated business income. Sec. 664(c)(2)(A). Since a unitrust with unrelated business taxable income does not lose exempt status, an active business asset may still be transferred to the trust and sold fairly quickly. If the asset is sold quickly, a donor may receive the capital gains bypass benefit with a modest cost for the 100% excise tax on trust unrelated business income.

Gift Taxation

If the donor is an income beneficiary of a one-life trust or the donor retains a testamentary power of revocation with a multiple life trust, there is no current gift. The power to revoke the income interest of a successor recipient must be testamentary and not inter-vivos. Reg. 1.664-3(a)(4).

Testamentary Power of Revocation

When a donor sets up a trust to benefit a non-donor, the donor often retains a testamentary power of revocation over the non-donor beneficiary's income interest. This power can be exercised only by the donor's will. If the donor does not retain a testamentary power of revocation, then the gift to the non-donor beneficiary is complete and there is potentially a current taxable gift. On the other hand, if the donor retains a testamentary power of revocation, then the gift to the non-donor beneficiary is considered incomplete. Because the gift is incomplete, there is no current taxable gift. Taxable gifts will be made when distributions from the trust exceeding the annual exclusion are made to the non-donor beneficiary. However, retaining the testamentary power of revocation may also have estate tax consequences for the donor. The estate tax consequences of a donor exercising or not exercising the right of revocation are explained below.

1. Donor has retained a right of revocation over a non-donor's income interest and does not exercise that power at donor's death. Under Sec. 2038(a), the present value of the income interest over which the donor has retained a right of revocation will be included in the donor's gross estate for estate tax purposes. For example, assume a donor set up a unitrust to benefit himself and his daughter, age 40, as successor income recipient. Donor retains a testamentary power of revocation over the daughter's income interest. At the time of the donor's death, the daughter is age 65 and the current trust value is $100,000. Based on the daughter's age and a current rate of the month of 3.0%, the daughter's income interest is $54,943. Because the donor has retained a right of revocation over this interest, the $100,000 trust is included in his taxable estate. There is a Sec. 2055(e) charitable deduction for $45,057 and $54,943 is a taxable transfer in the donor's gross estate.

2. Donor has retained a right of revocation over a non-donor's income interest and has exercised that power at donor's death. Donor funds a two-life charitable remainder unitrust with payouts to her for one life and names her niece as successor income recipient. The niece later inherits $10,000,000 from her grandfather. Donor elects to revoke by will the successor income interest of the niece. At the death of donor, the trust is distributed to charity. Because the donor has revoked the non-donor's income interest, there is no estate tax consequence. While the trust is included in donor's estate, there is a full Sec. 2055(e) charitable deduction.

Example 3.10.9A Testamentary Power of Revocation

Jane Donor creates a charitable remainder unitrust with a 5% payment to herself for life. After she passes away, the annuity will be paid to her daughter for life. Jane retains the right by will to revoke the income interest of the daughter. If she exercises this testamentary power of revocation, then the daughter would not receive income and the trust would pass to charity when Jane dies. Since there is a "string" on the income interest of the daughter, it is a contingent interest and there is no current gift. However, when Jane Donor passes away, the value of the income interest for her daughter will be in her taxable estate.

Estate Taxes

If the donor retains income, then the trust corpus will be included in his or her estate. Sec. 2036(a). With a one-life unitrust, there will then be a deduction for the full value of the trust. Sec. 2055. If the trust is funded for husband and wife and one spouse passes away, there then is a marital deduction. Sec. 2056(b)(8). Only if the successor income recipient is a child, nephew, niece or other family member, will there then be a taxable transfer. In this case, the taxable transfer will be the present value of the income interest of the non-charitable beneficiary as of the date of the trust grantor's death. The value of this taxable transfer will be calculated using the Sec. 7520 applicable federal rate and appropriate mortality tables.

If the estate is subject to estate tax, it is a requirement that the estate tax not be payable from an existing charitable remainder trust. Rev. Rul. 82-128. The estate tax will normally be paid from the residuary of the estate.

Tax Apportionment Provisions

With a testamentary unitrust, most state tax apportionment statutes would reduce charitable remainder trusts in order to pay taxes in the same manner as other non-charitable transfers. This has the result of substantially increasing the total estate tax. If the charitable trust is not to bear a portion of the estate tax, then it may be necessary to draft a specific tax apportionment provision in the will or living trust that allows the trust not to be reduced to pay estate tax.

Generation-Skipping Transfer Tax

Generation-skipping transfer tax is levied on direct skips, taxable distributions and taxable terminations. If the charitable remainder trust makes payments to a grandchild, great-grandchild or other skip person, there will then be taxable distributions.

The preferred course of action is to allocate a sufficient portion of the generation-skipping transfer tax exemption to the trust to produce a zero inclusion ratio. The amount of the exemption allocated will equal the value of the taxable transfer. Sec. 2632; Sec. 2613.

So long as the allocated exemption equals the calculated present value of the transfer to the non-charitable beneficiary, there will be no generation-skipping transfer tax. It should be noted that if there are benefits payable to both children and grandchildren, the entire non-charitable interest may need to be covered by allocated GSTT exemption.

Calculating Taxable Transfers

A charitable remainder trust consists of a gift of a remainder interest and the retention of an income interest. The present value of that remainder interest qualifies for the unlimited gift and estate tax charitable deduction. If the transferee is someone other than the donor, the donor's spouse or charity, then there will be gift or estate tax on the value of the retained income interest.

Quite often, a donor who sets up a trust to benefit a non-donor will retain a testamentary power of revocation over the non-donor's income interest. The right of revocation renders the gift incomplete with respect to the non-donor. As a result, there is no taxable transfer when the trust is first created. In that rare instance where a donor does not retain the right of revocation it will be necessary to determine the value of the taxable gift.

It is important to note that a donor is allowed to make non-taxable present interest gifts to recipients of an amount equal to the annual gift tax exclusion amount. Therefore, if the annual exclusion requirements are met for a gift to another person, then that income interest gift will only be taxable to the extent it exceeds the annual exclusion amount.

Taxable Transfer Scenarios

The following are several common taxable transfer scenarios and the resulting taxable gift calculations. Each scenario assumes that the donor has not retained a testamentary power of revocation over the recipient's income interest unless specified otherwise. Trust arrangements more complicated than those detailed below may require an actuary to perform the taxable gift calculations.

1. Donor is sole income recipient. If the donor sets up a CRT to pay income to himself for life with remainder to charity, he has made a gift to charity. The present value of the remainder gift to charity qualifies for the gift tax charitable deduction. The donor's retention of the income interest results in no further gift tax consequences.

2. Donor is co-income recipient with spouse. If the donor sets up a CRT to pay income to himself and his spouse for their lives or for a term of years, then the gift to the spouse will qualify for the Sec. 2523(g) unlimited gift tax marital deduction. The donor will also receive a charitable gift tax deduction for the gift to charity.

Note: If there is another non-charitable beneficiary apart from spouse, then the gift to the spouse will not qualify for the unlimited marital deduction. The gift to the spouse and the other non-charitable beneficiary will need to then be calculated.

3. A non-donor is sole income recipient. If the donor sets up a CRT to pay income to a non-donor (not his/her spouse) for life with remainder to charity, the donor has made a gift to charity and to the non-donor. The present value of the gift to charity qualifies for the gift tax charitable deduction. The gift to the non-donor is a taxable gift. The taxable gift is calculated as the present value of the income interest. For a charitable remainder unitrust, the taxable gift (present value of the income interest) is equal to the full amount transferred minus the present value of the remainder interest.

Example 3.10.9B Non-Donor Is Sole Income Recipient

Donor transfers $100,000 to a charitable remainder trust that names his 35 year-old son as sole income recipient for his lifetime. The unitrust payout percentage is 5% and the AFR is 3.0%. If the one-life remainder value of $14,436 is subtracted from $100,000, the present value of the son's unitrust interest-and therefore the gift-is $85,564. Because this is a vested income stream, the Donor reduces the gift by one annual exclusion amount and the balance is a taxable gift. Reg. 25.2503-3(b). When he files IRS Form 709 to report the gift, Donor allocates gift basic applicable exclusion equal to the taxable gift.

4. A non-donor is primary income recipient followed by Donor. If the non-donor is the primary income recipient for life followed by the donor, the taxable gift is the same as if the non-donor were the sole income recipient. The value of the taxable gift is equal to the present value of the income interest based on the non-donor's life. The calculation uses a one-life unitrust for the non-donor to determine the life interest. If the non-donor holds a vested income stream, Donor also reduces the gift value by one annual exclusion amount.

5. Donor is primary income recipient followed by the non-donor. If the donor is the primary income recipient followed by the non-donor as successor income recipient, then the taxable gift is equal to the present value of the non-donor's survivor income interest. The survivor income interest is equal to the difference between the present value of the income interest based on the donor's and non-donor's joint lives and the present value of the income interest based solely on the donor's life. With a future interest gift, there is no annual exclusion for a present vested income stream. The full value of the future income stream is offset by allocation from the gift basic applicable exclusion.

Example 3.10.9C Donor Is Primary Income Recipient Followed by Non-Donor

Donor, age 60, names himself as primary income recipient and Son, age 35, as successor income recipient of a $100,000 trust. The unitrust percentage is 5% and the AFR is 3.0%. The value of the son's successor income interest is calculated as follows:

PV of income interest based on joint lives	$87,194 (Two Life Calculation)
PV of income interest based on Donor's life	$61,733 (One Life Calculation)
PV of son's income interest (taxable gift)	$25,461

6. Donor and Non-donor are joint and survivor life income recipients. If the income interest is to be paid to the donor and a non-donor in equal shares for their joint lives with the decedent's portion payable to the survivor, the donor has made two gifts. First, the donor has made a gift to the non-donor of the present value of the non-donor's right to receive a survivor income interest from one-half of the trust. Second, the donor has made a gift of the present value of the income interest for the income recipients' joint lives from the remaining one-half of the trust.

Example 3.10.9D Donor and Non-Donor are Joint and Survivor Life Income Recipients

Donor, age 60, names himself and his Son, age 35, as joint and survivor income recipients of a $100,000 trust. The unitrust percentage is 5% and the AFR is 3.0%. When either Donor or Son passes away, the survivor will receive the entire income interest for his lifetime. The value of the taxable gift to Son is calculated as follows:

Gift 1 Calculation (Using One-Half of Trust Value or $50,000) - Donor and then Son

PV of income interest based on joint lives $43,597 (Two Life Calculation)

PV of income interest based on Donor's life $30,867 (One Life Calculation)

Equals Gift 1 Amount (PV of Son's Future Interest) $12,730

Gift 2 Calculation (Using One-Half of Trust Value or $50,000) - Son and then Donor

Calculation Uses Method from Example 3.10.9B

One-Half of Trust Value $50,000

PV of remainder interest based on Son's life $7,218 (One Life Calculation)

Equals Gift 2 Amount (PV Income to Son) $42,782

Total Combined Taxable Gift is $55,512. With the vested income stream in one-half the trust income, one annual exclusion is permitted. The balance is offset by allocation from the applicable gift exclusion amount.

Case Studies on Income, Gift, Estate and Generation-Skipping Transfer Taxes

Megan's CRUT - 'til Marriage Do Us Part: Kali Billings, 85, is a retired writer. Besides being an accomplished publisher, she is an active philanthropist. Throughout her life, Kali frequently gave of her time and money to many charities. In fact, she plans on leaving the bulk of her $1,000,000 estate to three of her favorite charities. While her family is very important to her, she feels they are all very successful and financially well off. However, Kali is concerned about her adopted daughter, Megan. Megan is a single 30 year old teacher living in a small town. Her salary is quite modest (especially in comparison to her siblings) and the likelihood of any significant increase over time is unlikely. Kali wishes to support her while she is single and building her career but does not want to alienate her other children. Ideally, she wants to provide support for Megan until she marries or until Megan reaches an annual salary of $60,000, whichever comes first. Kali's goal is to help Megan until her financial position is more in line with her other siblings.

Death and Taxes - The Madison Era of Giving, Part 1 of 7: Financial titan George Madison, Jr., has truly lived the American dream. A child of immigrant parents, he grew up during the Depression on the tough streets of New York. Thereafter, he served two arduous tours in World War II. While always grateful no matter where his place in life, George returned to the States determined to "make it big" and live the "good life." In particular, he wanted to lift many of the hardships his parents were enduring as poor immigrants. Consequently, George committed himself to the study of finance with an emphasis in investment banking. And the rest, as they say, is history.

Death and Taxes - The Madison Era of Giving, Part 2 of 7: Still on an emotional high from his multi-million dollar gift toward the construction of a state-of-the-art library (see last week's Case Study), George Madison, Jr. has a new focus in his life - making a difference in children's lives. After making the gift to the school, George had a life-changing realization. George spent his entire life building up his business and accumulating his fortune and rarely gave of his time or money to others. Like many people, George's career and family were his number one priorities. Now nearing the latter part of his life, George feels a strong urgency to do things differently. Knowing the importance education played in his success, George strongly desires to set up gifts that would provide educational opportunities for underprivileged children. In addition, he would like to take full advantage of the tax benefits of making such a gift. While he is becoming more generous as of late, George has no interest in increasing his cash "donations" to Uncle Sam.

The Dirtiest CRT Ever Created, Part 1 of 2: Sam Morello, 50, has been in the mining business for some 30 years. His company, Hard Hat Drillers, a sole proprietorship, owns and operates several mines in the northeast part of the country. The company's sole source of revenue is from its mining efforts. However, a national landscaping company has made Sam an offer to buy his entire surplus of dirt for $100,000. There has not yet been any contract or other formal agreement between the two parties. In total, Sam estimates that he has about 12,000 tons of dirt.