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Date

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Re: Possible Use of Charitable Remainder Trust

Dear \_\_\_\_\_,

Pursuant to your request, we have analyzed the possible benefits of using a Charitable Remainder Trust to own an interest in a home that will provide housing for \_\_\_\_\_ and \_\_\_\_\_. I have discussed in detail below that using the Charitable Remainder Trust in conjunction with an Irrevocable Special Needs Trust will provide significant income, and estate tax benefits to \_\_\_\_\_.

Please pay special attention to the section entitled "Recommendations" when reviewing the analysis below:

**FACTS**

\_\_\_\_\_ is a young adult with a disability, is grantor and beneficiary of the \_\_\_\_\_ Trust dated \_\_\_\_\_ (hereinafter referred to as the "Trust"). This Trust is revocable under its terms and the current Co-Trustees are \_\_\_\_\_, parents, \_\_\_\_\_ and \_\_\_\_\_. The Trust, as of \_\_\_\_\_, had \$\_\_\_\_\_ in assets and this Trust produces significant income annually.

\_\_\_\_\_ is not receiving any SSI/Medicaid or other public benefits and does not have an Irrevocable Special Needs Trust (herein after referred to as an "SNT"). It is contemplated that an SNT may eventually be drafted to protect many of \_\_\_\_\_'s assets.

Please note: This SNT will be a "First Party" SNT funded with \_\_\_\_\_'s money. This does not address additional future planning, including but not limited to, potential use of a "Third Party" SNT that the parents may create in conjunction with their estate plan.

\_\_\_\_\_, through his legal guardians, \_\_\_\_\_, is contemplating acquiring a residence that will be used for a home for him *and provide housing for up to three other individuals with disabilities*. The other individuals will pay rent (they are required to pay rent to maintain their benefits). The \_\_\_\_\_ family is contemplating transferring the remainder interest in the home to a Charitable Remainder Trust (herein after referred to as

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"CRT") to reduce both estate and income taxes for \_\_\_\_\_ and to provide a safe, quality home and support for \_\_\_\_\_. The proposed CRT will hold this residence and distribute the annual rental income to \_\_\_\_\_ SNT (once one has been established) for his lifetime. Upon \_\_\_\_\_'s death, the remainder of the CRT will be distributed to a qualified charitable organization. For the purposes of this Memorandum, it is contemplated that the charity will always be qualified under §170 of the Internal Revenue Code, ("IRC"). The \_\_\_\_\_ family is currently considering using \_\_\_\_\_ as the initial charity.

### ISSUES

1. Will the establishment of a CRT that pays an income stream to the SNT for the benefit of \_\_\_\_\_ qualify as a CRT under §664 of the IRC?

Pursuant to Revenue Ruling 2002-20 an SNT can receive the annual payment from a CRT for the life expectancy of the primary beneficiary of the SNT, provided the beneficiary is a "financially disabled individual" as defined in §6511(h)(2)(A). "An individual is financially disabled if such individual is unable to manage his financial affairs by reason of a medically determinable physical or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months." §6511(h)(2)(A). \_\_\_\_\_ qualifies as a financially disabled individual. Therefore, the maximum term of the CRT is permitted to be \_\_\_\_\_ life instead of 20 years.

2. What type of CRT should be established?

A "net income" CRT provides the most advantages for the \_\_\_\_\_ family, allowing the Trustee to provide \_\_\_\_\_ SNT, the lesser of all of the net income of the Trust or the percentage pay-out designated in the CRT. By federal law, this percentage paid out must be higher than 5% of the value of the CRT's assets. In all likelihood the rental income will not be greater than 5% of the CRT's net assets, but using a net income CRT allows the Trustee to distribute the net rental income regardless of the percentage of that amount. If the net income option is not used, then the Trustee will be required to distribute assets equal to the stated percentage regardless of the income earned by the Trust and may be required to distribute some of the principal of the CRT.

3. Will additional assets need to be transferred to the CRT?

A "net income" CRT will not require any additional assets other than the residence to be transferred into the CRT. \_\_\_\_\_, through the Trust, will purchase the home and transfer the remainder interest in the home to the CRT, retaining a life estate. \_\_\_\_\_'s retained life estate will be transferred into his SNT. Then \_\_\_\_\_ will distribute to the SNT all of the net income of the CRT. This net income will be generated by rental payments received from the other tenants in the home.

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The rental payments made by \_\_\_\_\_ will be made directly to his SNT and will not be included as income earned by the CRT. \_\_\_\_\_ is required to pay rent or his SSI benefits will be reduced by one-third (1/3) due to this in-kind support. The tenants of the home will have the leases with the CRT. \_\_\_\_\_ will have a lease with his SNT.

### **DISCUSSION**

A CRT, as defined in §664 of the IRC, must provide for the distribution of a specified payment, at least annually, to one or more persons. The term of the payment must be for the life or lives of the individual beneficiaries or for a term of no more than 20 years. Upon the termination of the non-charitable interest or interests, the remainder must either be held in continuing trust for charitable purposes or be paid to or for the use of one or more organizations described in §170(c) of the IRC. Generally, a qualified CRT is exempt from both State and Federal income tax, and the grantor is entitled to a charitable income, gift, and/or estate tax deduction based on the present value of the remainder interest ultimately passing to charity. IRC §664(d)(I), (2).

There are two types of CRTs. A charitable remainder annuity trust (hereinafter referred to as a "CRAT") is required to pay a sum certain annually to one or more beneficiaries of the fair market value of the trust assets valued as of the date such assets are transferred to the trust. A charitable remainder unitrust (hereinafter referred to as a "CRUT") is required to pay a fixed percentage of its net fair market value at least annually to one or more beneficiaries, this fixed percentage must be equal to at least 5% but not more than 50% of the net fair market value of the trust assets however, the value of the trust assets is determined annually. The amount paid by a CRUT fluctuates with the fair market value of the trust assets, whereas the annual payment from a CRAT remains constant.

In addition, the terms of the CRUT may provide for the payment of the lesser of the fixed percentage or the trust accounting income. If this payout option is close, the CRUT is referred to as a "net income" CRUT. Using a net income CRUT will not require the Trustee to consume any principal of the Trust if the net income fails to meet the designated percentage. The Trustee is simply required to distribute all of the income if the income does not meet this set percentage. If the income exceeds the set percentage, then the Trustee is only required to pay the set percentage designated in the Trust. A more complicated CRUT may, but need not, provide that any amount by which the trust accounting income falls short of the fixed percentage is to be paid out in subsequent years to the extent the trust's accounting income exceeds the fixed percentage in such later years. This "make-up" provision is useful to provide extra income. Also permitted are "flip" unitrusts. Such unitrusts start out with a "net income only" requirement, and then "flip" into a regular unitrust payment.

\_\_\_\_\_, as the grantor of a CRT, is entitled to an immediate federal income and gift tax charitable deduction. This deduction is determined by the current fair market value of the remainder interest ultimately passing to charity. Due to \_\_\_\_\_'s young age this

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will be a relatively small deduction. In addition, appreciated assets held by the CRT if sold by the trust shelter the gain from capital gains taxes. The creation of the income stream allows the grantor to benefit an individual for a term of years and at the same time benefit a charity.

Furthermore, the value of the assets (the home) plus appreciation during \_\_\_\_\_'s life will not be included in his gross estate and therefore, will reduce potential estate taxes paid when \_\_\_\_\_ passes away. Given the size of his estate, and the fact that the unified credit will sunset back to one million dollars (\$1,000,000) in 2011, this may be the first step in planning to minimize the federal estate and gift taxes due.

### **TERMS**

As stated above, the permitted term of a CRT is the beneficiary's life or a term of up to 20 years. In other words, if the beneficiary was another trust rather than a person, the longest permitted term is 20 years. A recent Revenue Ruling created an exception to this general rule for a "First Party" SNT. This Revenue Ruling provides that if the beneficiary of a charitable remainder unitrust is a separate trust established for the benefit of an individual who was "financially disabled" within the meaning of §6511(h)(2)(A) that the term may be the life of the "financially disabled" individual if certain terms are included. Rev. Rul. 2002-20. The trust must require that on the individual's death, assets of the recipient trust be distributed to the individual's estate or, reimburse any State that provided Medicaid benefits to the individual. After reimbursement, anything remaining could be distributed subject to the individual's exercise of a general power of appointment or other estate planning documents. Based on this Revenue Ruling, the IRS approves the charitable remainder unitrust paying to the SNT for the life of beneficiary of the SNT and treats the trust as if the payments are made directly to the individual with a disability for tax purposes. Thus protecting the income from being treated as income in a way that would negatively effect \_\_\_\_\_'s ability to receive benefits.

### **TYPE OF ASSETS USED TO FUND THE TRUST**

Section 664 and the associated regulations contain no explicit limitation on the type of property that may be contributed to a CRT. In practice, many trusts are funded with appreciated property, rather than cash, because no gain will be recognized on the transfer of the property to the trust. The interaction of §664 with other tax rules, such as the grantor trust rules, the unrelated business income tax §512, and the self-dealing, §4941 does, however, result in restrictions on the type of property that may be contributed. Transferring the wrong asset into a CRT may result in excise taxes or even disqualification of the charitable tax treatment. The two most common restrictions are the prohibition of income from "unrelated business income" and the prohibition of self-dealing between the grantor and/or beneficiary and the CRT. Although neither appears to be an issue in this case, both of these restrictions are discussed below.

### **UNRELATED BUSINESS INCOME**

Generally a CRT is exempt from income tax except in any year that it has unrelated business taxable income or debt-financed income. A CRT will lose its tax exemption for any year in which the trust has such income. This could occur, for example, if the trust borrowed funds to purchase investments, operated a business, or held mortgaged property. In addition, a CRT will lose its exempt status for a year in which it fails to timely make the required payment to the non-charitable beneficiary, or fails to make a timely payment of real property taxes or assessments, resulting in a lien on trust property. A CRT may lose its exempt status if used primarily for tax avoidance purposes, since the trust would then not have an exempt purpose. Louis W. & Waud Hill Family Foundation v. U.S. 347 F. Supp. 1225 (1972).

For regular income tax purposes, a distinction is made between trade or business activities and investment activities. Business expenses are deductible under §162 whereas expenses paid or incurred for the production or collection of income or for the management of property held for the production of income can be deducted as provided in §212. A similar distinction applies for purposes of the unrelated business income tax. Passive investment activities of an exempt organization are not considered a trade or business for purposes of the tax; moreover, dividends, interest, royalties, and other receipts from investment activities are expressly excluded from the scope of the unrelated business income tax under §512(b). Accordingly, the modifications exclude most passive income, such as dividends, as well as the deductions associated with such passive income, from the scope of the tax. IRC §512(b)(3)(A)(1).

### **SELF-DEALING**

The IRS treats CRTs under the same rules as private foundations. Accordingly, the IRC prohibits a CRT from engaging in acts of self-dealing. Leasing the property to a grantor or beneficiary would be considered an act of self-dealing. Section 4941(d) provides, "Except as provided in subparagraphs (2) and (3) of this paragraph, the leasing of property between a disqualified person and a private foundation shall constitute an act of self-dealing." Generally, disqualified persons include the Grantor and the beneficiaries of the CRT. If the entire residence is transferred to the CRT then the act of leasing to \_\_\_\_\_'s SNT will disqualify the CRT, because \_\_\_\_\_ would be treated as a disqualified person.

On the other hand, retaining a life estate in the property should not cause any self-dealing. The value of the life estate retained is subtracted from the value of the residence when the charitable deduction is calculated. The CRT will not be engaging in any self-dealing because \_\_\_\_\_, although a disqualified person, is not receiving a benefit from the CRT by living in the home, as he has retained this right and transferred it to his SNT.

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### **SSI/MEDICAID**

The transfer to the CRT will be deemed a divestment by \_\_\_\_\_ for purposes of determining SSI/Medicaid eligibility, and therefore, will be included in any look back period when \_\_\_\_\_ applies for benefits. In addition, \_\_\_\_\_ will pay rent to the SNT from his SSI benefits once he is eligible. Under current Social Security Administration regulations if \_\_\_\_\_ is allowed to live in the home rent-free his SSI benefits will be reduced by one-third (1/3) due to in-kind support and maintenance. However, keep in mind once the money is in the SNT it can be used for \_\_\_\_\_'s benefit for other items (see the enclosed list of permissible distributions from an SNT).

### **LEASES**

The primary assets held by the CRT will be real property that will be leased to individuals. The terms of these leases will provide for fair market value rent and require that the tenants may be removed upon the discretion of the Trustee[s] of the CRT. In addition, the Trustee[s] of the CRT will mirror the Trustees of the SNT for \_\_\_\_\_'s benefit. This provision will allow us to insure that \_\_\_\_\_'s right to use and enjoy the property is always the primary consideration without infringing on any of the rules regarding self-dealing.

### **PROVISIONS OF THE SNT REQUIRED BY REVENUE RULING 2002-20**

Revenue Ruling 2002-20 allows a CRT to use the life expectancy of the beneficiary of the SNT as the term of the trust but requires that the SNT contain specific dispositive provisions to insure that the SNT and/or the beneficiary reimburse any State for the Medicaid benefits he received. We recommend that the provisions of SNT provide that on \_\_\_\_\_'s death the assets are paid to his estate. Currently, the State of Michigan has not implemented estate recovery. If estate recovery is implemented then upon \_\_\_\_\_'s death the State will seek reimbursement for the Medicaid benefits he received from his estate. The life estate maintained by the SNT (which expires upon \_\_\_\_\_'s death) and any income paid to the SNT from the CRT that was not distributed for \_\_\_\_\_, will likely be the only assets in the SNT, so the State of Michigan's ability to recover any assets is significantly limited if and when estate recovery is implemented. If estate recovery is not implemented (there appears to be other proposals (i.e., estate preservation being discussed) then no payback will occur in Michigan.

### **RECOMMENDED PROVISIONS OF THE SNT TO PROTECT**

The CRT must provide that upon the death of \_\_\_\_\_, the assets are distributed to a charitable organization as defined in §170 of the IRC. It is anticipated that the initial charitable beneficiary will be \_\_\_\_\_. The provisions of the CRT may allow the donor or the Trustees to change the ultimate recipient of the remainder to a different qualified charity. We recommend specific language be included to allow the Trustees to change the beneficiary to another organization qualified as a charity under §170 of the IRC. This provision will allow the

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assets of the \_\_\_\_\_ to benefit the organizations that have provided the most benefits to \_\_\_\_\_ and protect him if the organization changes significantly in the future.

### **RECOMMENDATIONS**

The property should remain in \_\_\_\_\_'s Trust until the home is completed. On completion of the home, the Trust should transfer the home directly to the CRT subject to the retained life estate. The life estate should then be transferred to \_\_\_\_\_'s SNT (which will then lease the property back to \_\_\_\_\_). The CRT should enter into leases with tenants.

The provisions of the CRT will require the Trustee to distribute the lesser of the net income of the CRT or the stated percentage in the CRT to \_\_\_\_\_'s SNT at least annually. The rent generated from the leases between the CRT and the tenants will be collected and used to defray the costs of the CRT. The remainder of the rent (or net income) will be distributed to \_\_\_\_\_'s SNT. We do not envision that the rent charged will ever exceed the payout percentage as stated in the CRT. SNT will annually receive the net income of the CRT. These payments can be made quarterly or annually to the SNT. The SNT will use this income and other assets to supplement \_\_\_\_\_'s SSI benefits (see the attached list of permissible distributions).

We recommend that the same Trustees serve for both the CRT and \_\_\_\_\_'s SNT insuring both trusts will act in his best interest. In addition, the Trustees should be given the specific right to replace the charitable remainder beneficiary with another qualified organization upon their sole discretion. This right to change the beneficiary will help to \_\_\_\_\_ continues to provide superior services to \_\_\_\_\_.

The gift that establishes the CRT will exceed the monthly divestment penalty amount and therefore will create ineligibility for \_\_\_\_\_ to apply for government benefits. \_\_\_\_\_'s remaining assets held outside the SNT in his Trust are more than enough to pay for any long-term care he needs prior to his eligibility for benefits.

It is also recommended that the leases with the other beneficiaries be drafted in a manner that protects \_\_\_\_\_ rather than the way that most benefits the Trust. For example, a lease can have a long term to provide security. The landlord, however, relinquishes control of the choice of tenant. The landlord in this case is the CRT, which currently benefits \_\_\_\_\_ only until his death. During \_\_\_\_\_'s life, the SNT is the income beneficiary. If a shorter term is provided for, there is more of a risk that a tenant may not be found and the revenues will not be sufficient to satisfy the obligation under the terms of the CRT. However, the Trustees will have more flexibility to remove tenants that do not get along well with \_\_\_\_\_. In other words, using shorter leases than may be industry standard may be practical and provide the Trustees the flexibility to protect \_\_\_\_\_ and ensure his choice of housemates.

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After you have had an opportunity to review the above, please feel free to contact me. If I am not immediately available you may discuss the use of a charitable remainder trust in conjunction with a special needs trust with my colleague, \_\_\_\_\_. If you decide to proceed with drafting both of these trusts, please contact me, as I will not begin the drafting process until we discuss this matter further.

Very truly yours,

**Patricia E. Kefalas Dudek & Associates**

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