



CRT.com—Structuring a Charitable Remainder Trust for the High Tech Insider

by Reynolds T. Cafferata and Kirk F. Maldonado

The founder of an internet-based corporation whose stock is publicly traded (Founder) may be an obvious candidate for a charitable remainder trust (CRT). A CRT allows the Founder to meet both philanthropic and financial planning needs.

The CRT achieves the Founder's philanthropic goals by allowing him or her to make a significant deferred gift to charity, which can be a public charity or the Founder's private foundation. For that gift, the Founder is entitled to a charitable income tax deduction for the value of the remainder interest that goes to charity. The CRT helps the Founder to diversify his or her portfolio because the CRT sells the Founder's stock free of capital gains tax and invests the entire sales proceeds in a diversified manner. The CRT then distributes an amount (typically a fixed percentage of the value of the CRT) each year to the Founder and/or to his or her family members.

Although the CRT offers many benefits to a Founder, establishing a CRT in these circumstances may present special challenges because the Founder and, derivatively, the CRT typically are subject to restrictions on the ability to resell the stock. In addition, the typical youthful age of the Founder may present special planning considerations.

Effect of Restrictions

In order to be fully deductible, the Founder's stock that is given to the CRT must be freely tradable. If securities laws or contractual provisions would restrict, even temporarily, the sale of the stock, the amount of the Founder's charitable deduction will be reduced. Specifically, if the stock is not freely tradable and the remainder beneficiary of the CRT is, or can be, a private foundation, the Founder's income tax deduction for the contribution to the CRT will be limited to his or her tax basis in the stock, which is often nominal.¹ If the remainder beneficiary is limited to a public charity, trading restrictions will reduce the fair market value of the stock, thus reducing the charitable deduction.² The reduction in fair market value for trading restrictions, however, typically will not reduce the deduction all the way down to the Founder's tax basis.

Sources of Restrictions

The following analysis applies to Founders who, at the time of the gift to the CRT, are executive officers, directors or major shareholders of the corporation (Issuer) whose stock will be contributed to the CRT. The four following sources of limitations should be considered:

- 1) Section 16 of the Securities Exchange Act of 1934 (Section 16);
- 2) Rule 144 promulgated by the Securities Exchange Commission (SEC);
- 3) restrictions under corporate policy or contract; and
- 4) the beneficial ownership disclosure rules.

In funding a CRT, there are two transfers that must be considered. First, there is the transfer of the Founder's shares to the CRT. Second, there is a transfer when the CRT sells the shares in the open market.

Section 16

Section 16 applies only to persons who are the executive officers, directors and more than 10% shareholders of a publicly traded corporation (Insiders). Section 16(a) requires that Insiders file certain reports regarding their holdings of, and transactions involving, Issuer stock. Section 16(b) requires that Insiders pay to the Issuer any profits that the Insider makes on the purchase and sale (or sale and purchase) of stock of the Issuer within a six-month period. It is important to remember that the transactions need *not* involve the same shares.

The following discussion assumes that at all times during the existence of the CRT, the CRT owns *less* than 10% of the Issuer's stock, and that the Founder is the income beneficiary of the CRT.

Transfer to the CRT. The gift of the stock to the CRT will be exempt from the short-swing profits recovery rules of Section 16(b).³ However, the gift is subject to the reporting obligations of Section 16(a), so that it needs to be reported on a Form 5 (within 45 days after the end of the Issuer's fiscal year in which the transfer occurred).⁴

Transactions by CRT. An independent person with complete investment control and voting power should be trustee of the CRT. Generally, the trustee should be a large financial institution. If the CRT has an independent trustee, the donor will *not* be considered to have any investment control over the assets of the CRT, so that the CRT's transactions involving issuer's stock will *not* be reportable by the Founder.⁵ Because the transactions are not reportable by the donor under Section 16(a), they are, therefore, exempt from the profit recovery rules of Section 16(b).⁶

Rule 144

Rule 144 limits the volume of sales of an Issuer's stock *in the open market* by its "Affiliates." A person is an Affiliate of an Issuer if he or she is an executive officer, director or major shareholder who can

affect the policies of the Issuer. Even if the Founder is not an Affiliate, resales of the Founder's stock will be subject to certain restrictions under Rule 144 (Restricted Stock) unless the Founder acquired the stock in a transaction that involved an offering that was registered with the SEC. The following discussion assumes that the Founder's stock is restricted stock.

Gift to CRT. Rule 144 does *not* apply to the gift of the stock to the CRT because it is a *private* transaction (i.e., one that is *not* affected in the public markets).

Status of CRT. Because the Founder and/or members of the Founder's immediate family who reside with the Founder will be the income beneficiaries of the CRT, the CRT also will be deemed to be an Affiliate.⁷

Resales by the CRT. The following rules apply to any public sales of the Founder's stock that the CRT effectuates.

Sales within One Year. Restricted Stock cannot be sold until it has been held for at least one year.⁸ However, because the CRT acquired the shares from the Founder by means of a gift, the CRT gets credit for the holding period of the Founder, so that the period of time during which the CRT is considered to have held the stock includes the period during which the Founder owned the stock.⁹

Sales After One Year. After the combined holding period for the Founder's stock is one year, it can be sold in the open market in accordance with the following conditions:

- 1) **Current Information.** The Issuer must have filed its entire SEC periodic filing obligations for the last 12 months. For this purpose, the CRT may rely on a statement in the Issuer's most recent annual or quarterly report to shareholders (whichever is applicable) that the Issuer has actually filed those reports.¹⁰
- 2) **Notice Requirement.** If the amount of the Issuer's stock to be sold by the CRT¹¹ during any three-month period either:
 - 1) exceeds 500 shares; or
 - 2) has an aggregate sales price in excess of \$10,000, then three copies of the Form 144 must be filed with the SEC and a copy sent to the principal stock exchange on which the Issuer's stock is traded.¹² This filing must be affected concurrently with either the placing with a broker of an order to execute a sale in reliance on Rule 144 or the execution of the sale directly with a market maker.¹³
- 3) **Volume Limitations.** The number of shares that the CRT may sell within a three-month period may not exceed the *greatest* of:
 - 1% of the outstanding shares;
 - the average weekly reported volume during the four calendar weeks preceding the filing of the Form 144; or
 - the average weekly volume of trading in such securities reported through the consolidated transaction reporting system under SEC Rule 11A3-1 during the four-week period described above.

For purposes of this volume limitation, the sales by the Founder must be aggregated with those of the CRT for the

one-year period following the date on which the shares were given to the CRT.¹⁴

This aggregation applies even if the trustee of the CRT is independent of the Founder.¹⁵ Even after aggregation ceases to apply, the CRT will remain subject to the volume limitations as long as the Founder remains an Affiliate.

- 4) **Manner of Sale.** The sales by the CRT must be effected in brokers' transactions or directly with a market maker, in accordance with the conditions specified in Rule 144(f) and (g). Generally, this will not be a problem for sales by the CRT.

Planning Tip: To maximize the charitable income tax deduction, the Founder will not want to transfer the stock to a CRT until he or she has held the stock for at least one year. Even if the Founder has held the stock for more than a year, the Founder should enter into an agreement with the CRT to limit his or her individual sales so that the CRT will always be able to sell all of its shares without the combined sales violating the volume limit of Rule 144. Such an agreement is crucial if the remainder beneficiary of the CRT is a private foundation. Without such an agreement, the Founder's income tax deduction will be limited to his or her basis in the stock.¹⁶

Cessation of Affiliate Status. If and when the Founder ceases to be an Affiliate, then the CRT also will cease to be an Affiliate. If the combined holding period for the Founder's stock exceeds two years *and* the Founder has *not* been an Affiliate for at least three months, then the CRT may sell the shares it holds without regard to:

- 1) the current information requirement described in "Current Information" above;
- 2) the notice requirement described in "Notice Requirement" above;
- 3) the volume limitation described in "Volume Limitations" above; and
- 4) the manner of sale requirement described in "Manner of Sale" above.

Planning Tip: A Founder who is considering resigning his or her position with a corporation may want to wait at least three months after resigning to fund a CRT to avoid Rule 144, assuming that he or she will have held the Issuer's stock for at least two years at that time.

National Conference on Planned Giving Exhibitor

**Crescendo Interactive
Booth #60 & 61**

The *SOURCE* for Planned Gifts Software, Seminars, Videos, Teleconferences and Internet. With over 3,200 organizations and 4,500 users nationwide, Crescendo is the Industry Leader providing the most comprehensive and powerful planned giving software and support services available. Marketing proposals include donor-friendly flowcharts, color graphics, text explanations *plus* trust documents. User-friendly Windows 95/98/2000/NT format. Call 800-858-9154 for a 90-day free trial. Visit www.crescendosoftware.com, www.GiftLaw.com and www.GiftLegacy.com.

National Conference on Planned Giving Exhibitor

**Online Technologies, Inc.
Booth #9**

Online Technologies, Inc., headquartered in Little Rock, Arkansas, since 1985, is a leading provider of audio/visual equipment and services. On behalf of the professional Financial Planner, we have negotiated special discounted pricing with InFocus Systems, the market leader in projection technology, to offer you their entire line of award-winning computer/video projectors at an exceptionally low price point! Leasing terms also available. Contact Becky Dively at 800-687-4647 for details or visit our extensive web site: www.onltech.com

Issuer's Trading Policy and Contractual Limits

The Founder will need to verify that the sale of the Founder's stock by the CRT does not violate any of the trading policies of the Issuer. For example, many Issuers prohibit their executives (and related persons) from buying or selling stock during certain periods of the year. However, if the trustee of the CRT is an independent financial institution that does not have access to any nonpublic information regarding the Issuer, then logically, the Issuer's insider trading policy should *not* apply to the CRT. This result should be confirmed with the Issuer's general counsel. Similarly, the Founder's gift of the stock to the CRT should be effected in accordance with the Issuer's trading policies (to the extent that they would apply).

In addition to the Issuer's trading policy, the Founder may be subject to a lock-up agreement with the Issuer's underwriter that limits the sale of the Founder's stock for a period of time (e.g., six months) following the initial public offering of the Issuer's stock. If so, the CRT may need to obtain a waiver of this restriction from the underwriter to effect any sales during that time period.

Beneficial Ownership Disclosure Obligation

A publicly traded corporation must include in its proxy statement a table showing the beneficial ownership of its stock.¹⁷ If the Founder uses an independent trustee, who has complete voting and investment power over the shares, the Founder need *not* include in his or her holdings the shares held by the CRT. (While this is not a restriction upon sales, many Founders seek to avoid the publicity attendant to their sales of Issuer stock.)

Young Donors

The young age of the Founder may present some challenges when structuring a CRT. A CRT must have: 1) a minimum annual payment to the non-charitable beneficiary of 5% of its value; and 2) a charitable remainder value at the time of the CRT's creation of 10% of its value.¹⁸ Both of these rules cannot be satisfied with respect to a CRT for the life of a donor under age 22, or for the joint and survivor lifetimes of a couple if both spouses are under the age of 35.

To create a qualified CRT, in the case of a young couple, the term of the benefits under the CRT must be either: 1) for the benefit of both of them, but limited to a term of years not in excess of 20¹⁹; or 2) based on the life of only the husband or of the wife (assuming that he or she is at least age 22). If only one spouse's life is used, the CRT can be for the *longer* of that spouse's life or 20 years.

If a young couple chooses to create a CRT for the life of only one spouse, they can reduce the impact of the premature death of the beneficiary spouse by purchasing a level premium term insurance policy on the life of the beneficiary spouse. A level premium term policy pays a death benefit if the insured dies while the policy is in force, but the amount of the premium is a fixed amount for a specified term. For young insureds, these policies are inexpensive because it is statistically unlikely that a 35-year-old will die in a five-, 10- or even 20-year period.

In all cases, the young couple likely will want to limit the beneficiaries of the CRT (regardless of overall maximum term) to the husband and the wife to avoid losing the marital estate tax deduction if either spouse dies during the trust term.²⁰ If the CRT is for the benefit of the husband and the wife, but also for other possible beneficiaries such as children, no marital estate tax deduction is allowed for the interest in the CRT passing to the surviving spouse.²¹ Accordingly, if the CRT benefits anyone other than the surviving spouse, applicable credit (if available) may be used, and estate tax will be due to the extent applicable credit amount is insufficient, on the entire value of the CRT at the death of the first spouse to die with a deduction only for the then present value of the remainder interest for charity.

Since the CRT likely will be limited in all instances to benefiting only the husband and the wife, a young couple can buy a second-to-die level premium term life insurance policy to provide for their children, if necessary. This type of insurance would be inexpensive and would replace the payments the family would have received from the

continued on page 50

CRT had at least one of the parents survived the CRT term. A more sophisticated technique is to layer five-, 10- and 15-year level term life insurance policies because as payments are received from the CRT, the loss caused by the beneficiaries' death declines over time.

Conclusion

Securities law is a body of law with at least the same level of complexity and subtleties as is found in the Internal Revenue Code. Accordingly, in all cases, experienced securities counsel should be consulted regarding any gift of Issuer stock by an Insider.

If there are any restrictions on transfer of a Founder's stock, he or she may not want to name a private foundation as the remainder beneficiary of the CRT because the entire deduction could be lost if any restriction was not removed prior to the gift of the stock to the CRT. On the other hand, if the remainder beneficiary were a public charity, any transfer restrictions would reduce the value of the Founder's charitable income tax deduction, thus allowing some margin for error.

If the Founder is young, non-traditional trust terms and term life insurance may be helpful in planning the CRT. If a planner can successfully resolve these issues, he or she may be able to capture some of the newly created wealth of the Founders of public companies for the planner's charity. ☐

Endnotes

1. IRC § 170(e)(5); PLR 9247018.
2. Rev. Rul. 77-287, 1977-2 C.B. 319.
3. 17 CFR § 240.16b-5.
4. 17 CFR § 240.16a-3(f).
5. 17 CFR § 240.16a-8.
6. 17 CFR § 240.16a-10.
7. SEC No-Action Letter issued to Riordan & McKinzie (May 5, 2000).

8. 17 CFR § 230.144 (d).
9. 17 CFR § 230.144(d)(3).
10. 17 CFR § 230.144(c)(1).
11. For this purpose, sales by the CRT are *not* aggregated with sales by the Founder.
12. 17 CFR § 230.144(h).
13. 17 CFR § 230.144(h).
14. 17 CFR § 230.144(e).
15. SEC No-Action Letter issued to Riordan & McKinzie (May 5, 2000).
16. See IRS PLR 9734034.
17. 17 CFR § 239. 403.
18. IRC §§664(d)(1)(A), 664(d)(2)(A).
19. *Id.*
20. IRC § 2056(b)(8).
21. *Id.*



Reynolds T. Cafferata is a principal in the Los Angeles office of the law firm of Riordan & McKinzie. His practice includes charitable giving and general estate planning. He is a frequent speaker on charitable and estate planning topics, and was a witness at the IRS hearings for charitable remainder trust regulations. Cafferata is a past president of the Nevada Planned Giving Roundtable and is the government relations chair of the Planned Giving Round Table of Southern California. He is a member of NCPG's Board of Directors and is a member of the California and Nevada Bars.



Kirk F. Maldonado is a principal in the Costa Mesa office of the law firm of Riordan & McKinzie. He practices in the area of employee benefits and executive compensation. He has lectured extensively and has authored over 50 articles on employee benefits and executive compensation matters, including BNA Tax Management Portfolio #362, Securities Laws Aspects of Employee Benefit Plans.

Securities Laws Consequences of Transactions Involving CRTs

Transfer to CRT	Sales by CRT
Section 16 Consequences	
No possible liability, but must report transaction.	No possible liability and need not report transaction. ¹
Rule 144 Consequences²	
Rule 144 n/a (private transaction).	Must hold stock for at least one year. ³ Sales after one year: <ul style="list-style-type: none"> • Corporation must be current in its SEC reports. • CRT must file notice (Form 144). • Must sell in "broker's transaction." • Subject to volume limitations, which includes sells by Founder. Sales from cessation of "Affiliate" status: <ul style="list-style-type: none"> • Must have held stock for at least two years.³ • Must have not have been an "Affiliate" for at least three months.

1. Assuming that the trustee of the CRT is an independent financial institution.
 2. It is assumed that the Founder is an "Affiliate" of the corporation and that the stock was not purchased as part of a registered public offering.
 3. This includes both the holding period of the Founder and of the CRT.