ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Assembly Committee on Revenue and Taxation	Analyst:	Scott McFarlane	Bill Number:	AB 2687
Related Bills:	See Legislative History	Telephone:	845-6075	Introduced Date:	March 12, 2012
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Charitable Remainder Trust Conformity

SUMMARY

This bill would modify California tax law to generally conform to the federal tax treatment of Charitable Remainder Trusts (CRTs) that have unrelated business taxable income (UBTI).

RECOMMENDATION

No position.

REASON FOR THE BILL

According to committee staff, the purpose of the bill is to generally conform to the federal treatment of CRTs that have UBTI in order to allow such trusts to retain their exempt status.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2011.

BACKGROUND

For federal and California purposes, a CRT is generally a trust that:

- Is funded by a donor's irrevocable contribution of cash or property,
- Provides the donor and/or other designated beneficiaries an income stream for a specified period, commonly for the life of one or more beneficiaries, and
- Contributes the remainder of the trust to charity.

The remainder to be contributed to charity must be at least ten percent of the value of the assets contributed to the trust, and the donor is allowed a charitable-contribution deduction in the year of the contribution for the present value of the remainder. A CRT is generally tax exempt; that is, income that would otherwise be currently taxable is generally not taxable until it's distributed to a beneficiary, unless the trust has UBTI. If a CRT has UBTI in any tax year, then:

- For federal purposes, the CRT keeps its general tax-exempt status, but is subject an excise tax equal to the amount of UBTI; and
- For California purposes, a CRT loses its tax-exempt status and is taxed as a regular complex trust.

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ANALYSIS

FEDERAL/STATE LAW

Federal Law

In General

There are two general types of CRTs:

- Charitable remainder annuity trusts (CRATs), and
- Charitable remainder unitrusts (CRUTs).

CRATs

A CRAT is a trust that is required to pay, at least annually, a fixed dollar amount of at least 5 percent, but not greater than 50 percent, of the initial fair market value (FMV) of the trust's assets to a non-charity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity.

CRUTs

A CRUT is a trust that is generally required to pay, at least annually, a fixed percentage of at least 5 percent of the FMV of the trust's assets determined at least annually to a non-charity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A trust does not qualify as a CRUT if the percentage of assets that are required to be distributed annually is greater than 50 percent of the FMV of such assets.

There are three types of CRUTs:

- Standard CRUTs (SCRUTs),
- Net-Income with Make-Up CRUTs (NIMCRUTs), and
- Flip CRUTs (Flip-CRUTs).

SCRUT

An SCRUT is required to pay, not less often than annually, a fixed percentage of the net FMV of the trust assets, determined annually, to designated beneficiaries. The fixed percentage must be at least five percent but not greater than 50 percent of the FMV of trust assets, determined annually.

NIMCRUT

A NIMCRUT is required to pay, not less often than annually, the *lesser* of an SCRUT-type fixed percentage or the CRUTs trust income for the taxable year. If the trust income for the taxable year is less than the SCRUT-type fixed percentage, the difference between the two is accumulated as the “make-up” amount. A NIMCRUT may pay beneficiaries the accumulated “make-up” amount in subsequent taxable years, and is required to pay any “make-up” amount to the extent that trust income exceeds the SCRUT-type fixed percentage in any taxable year.

Flip-CRUT

A Flip-CRUT is combination of an SCRUT and a NIMCRUT. A Flip-CRUT starts out as a NIMCRUT, and then "flips" to become an SCRUT upon the occurrence of a triggering event. A triggering event may be a marriage, a divorce, a death, the birth of a child, or the sale of unmarketable securities.

Income Character of Distributions

Distributions from a CRT are treated by beneficiaries in the following order:

(1) Ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred;

(2) Capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred;

(3) Other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and

(4) Corpus. (Corpus means the assets contributed to the trust.)

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary in the year that the CRT amount is required to be distributed even though the CRT amount is not distributed until after the close of the trust's taxable year.

Remainder Requirements

A trust does not qualify as a CRT unless the value of the remainder interest is at least 10 percent of the initial FMV of the assets contributed to the trust.

Taxation of CRTs

A CRT is exempt from income tax unless the trust has any UBTI. UBTI generally is the income from a trade or business regularly conducted by an exempt organization and not substantially related to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from the activity. Common types of CRT UBTI include an investment in an active trade or business (e.g., a partnership or limited liability company interest), a working interest in an oil and gas well, and unrelated debt-financed income from trading on the margin or other borrowing.

The Tax Relief and Health Care Act of 2006 (TRHCA) modified the federal tax treatment of a CRT that has UBTI, as follows:

Pre-TRHCA Rules

Prior to the TRHCA, the federal rules that applied to a CRT that had UBTI were generally the same as the current California rules; specifically, for taxable years beginning before January 1, 2007, a CRT that had UBTI in any taxable year lost its tax-exempt status for that year, and the CRT was taxed as a regular complex trust. As such, the trust was allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year.

This rule was applied on a year-by-year basis; that is, a CRT with UBTI lost its general tax exemption for the year, but such CRT would continue to be tax exempt in subsequent years in which it had no UBTI.

Post-TRHCA Rules (Current Federal Tax Treatment)

The TRHCA provides that for taxable years beginning on or after January 1, 2007, a 100-percent excise tax is imposed on the UBTI of a CRT. This replaces the rule that took away the income tax exemption of a CRT for any year in which the trust had any UBTI. Consistent with prior law, the tax is treated as paid from corpus. And, the UBTI is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

California Law

California law generally conforms to the federal rules for CRTs, but specifically does not conform to the UBTI rule change made by the TRHCA. Thus, a CRT that has UBTI in any taxable year loses its general exemption from income tax for that year and is taxed as a regular complex trust. Such a CRT is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year.

And, similar to the federal law prior to the TRHCA, the UBTI rule is applied on a year-by-year basis; that is, a CRT that has UBTI loses its general tax exemption for the taxable year, but continues to be tax exempt in subsequent years in which it has no UBTI.

THIS BILL

This bill would modify California law to generally conform to the current federal tax treatment of CRTs that have UBTI, except that in lieu of a 100-percent excise tax on UBTI, California UBTI would be subject to tax under the graduated personal income tax rates that range from 1 percent to 10.3 percent.[1]

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

SB 401 (Chapter 14 of the Statutes of 2010) changed California's "specified" date of conformity to the Internal Revenue Code from January 1, 2005, to January 1, 2009, and modified California law to specifically not conform to the CRT-UBTI rule change that was made by the TRHCA.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. A review of the laws of these states found that none of them take away a CRT's general tax-exempt status in any year the CRT has UBTI.

[1] See R&TC sections 17041 and 17043.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB 2687 For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2012		
2011-12	2012-13	2013-14
-$400,000	-$300,000	-$300,000

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that a CRT should not lose its tax exemption when it has a small or modest amount of UBTI.

Opponents: Some may argue that a CRT that has any amount of UBTI should continue to lose its tax exemption.

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