Charitable Remainder Trust

Do your clients have highly appreciated assets, such as stock or real estate, in their portfolios?

Would your clients like to increase their income and reduce current income taxes at the same time?

Do you have clients who want to maximize their estates for their heirs and leave substantial gifts to their favorite charities?

If so, you owe it to your clients to check out the benefits of a Charitable Remainder Trust (CRT).

What is a Charitable Remainder Trust (CRT)?

The Tax Reform Act of 1969 created the Charitable Remainder Trust, an irrevocable tax-exempt trust available in annuity or unitrust formats. Generally, a partial interest gift to a charitable organization does not qualify for the income, gift, or estate tax deduction. A CRT is an important exception to this "partial interest rule."

To establish a CRT, a donor transfers property to the trust and receives an income tax deduction equal to the asset's fair market value minus the present value of the stream of payments the income beneficiary is to receive from the trust. The interest rate used to determine the present value is the Internal Revenue Code Section 7520 Interest Rate. This rate changes monthly, however the donor has the option to use the current month's rate or one of the previous two month's rates. A higher rate creates a higher income tax deduction.

The income beneficiary can receive income in the form of an annuity or unitrust. When income is distributed, it must be classified according to a four-tiered taxation system. For tax purposes, trust distributions must be made in the following order:

1. Ordinary Income
2. Capital gain
3. "Other income"
4. Principal

Charitable Intent

A Charitable Remainder Trust is a great planning tool if – and only if – your client has charitable intent. Maybe they are passionate about their church, alma mater, or a cause such as breast cancer research. Charitable intent is necessary because CRT rules require that the present value of the remainder interest be at least 10 percent of the fair market value of the assets transferred to the trust. If $1 million is transferred to the trust, the present value to the charity must be a minimum of $100,000. When an asset is transferred to a CRT, the donor avoids current tax on the gain inherent in the asset and the CRT pays no tax when the asset is sold. This is a very valuable advantage to a CRT, however clients should not use this technique just for tax advantages. Tax advantages combined with charitable intent are what make the CRT a great planning tool.

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The preceding summary is intended to be a general discussion of the topic presented, and is based on our current understanding of applicable tax laws, regulations and rulings. In actual practice, the transaction discussed may be more complex and will require the attention and expertise of professional advisors. In no way should this summary be construed to constitute tax or legal advice. For Advisor Use Only.

Charitable Remainder Annuity Trust (CRAT)

When a CRAT is used, the trustee is required to pay a specified annual annuity to the donor or other designated individuals for a certain period of time. The amount of the annuity must equal at least 5 percent and not be greater than 50 percent. The 10 percent required remainder interest is determined at the time the asset is transferred. Additionally, there must be a 95 percent probability that the charity will receive the 10 percent remainder. The CRAT's income beneficiary must receive the required annuity payout each year regardless of the return inside the trust. This will sometimes require principal to be invaded.

Charitable Remainder Unitrust (CRUT)

When a CRUT is used the trustee is required to pay income beneficiaries a specified percentage of the value of the trust assets each year. The trust's assets are revalued each year. If the value increases, the payout increases; if the value decreases, the payout will decrease accordingly. As with the CRAT, the specified percentage of the CRUT must equal at least 5 percent and be no greater than 50 percent. The value of the charitable remainder must be at least 10 percent of the net fair market value of all assets transferred to the trust. One key advantage of the CRUT is the ability to add assets to the trust at a future date.

Which Type Of Remainder Trust is Best for Your Client?

The key questions to ask are:

- Do you foresee making additional contributions? Yes = Unitrust
- Are you willing to tolerate fluctuating income? No = Annuity Trust

Watch Out for These Circumstances

Caution should exercised if a client is interested in leaving the remainder interest to a private foundation. In this situation, the charitable deduction could be limited to the cost of the asset contributed. The type of asset can also change the percentage limitation.

Special care must also be taken when assets have debt associated with them. This could create taxation to the trust and donor, plus the trust could lose the charitable classification.

Finally, be careful if the sale of the asset already seems likely. If an agreement is already in place, the donor would be required to recognize the capital gain, losing one of the key advantages of the CRT.

Wealth Replacement Trust

Many times potential donors to a Charitable Remainder Trust are reluctant to give substantial assets away because of their concern for their heirs. One way to overcome this reluctance is to replace the asset with life insurance in an irrevocable life insurance trust. When done correctly, the life insurance can be income and estate tax-free to the heirs. Many times this will increase the net amount passed to heirs after tax. The combination of the tax deductions and cash flow from the CRT are usually more than enough to fund the wealth replacement life insurance policy.

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