Charitable Remainder Trust

A charitable remainder trust technique permits a donor (you) to irrevocably transfer money, real estate, securities or other assets to a trust that will then pay you an income for life or for a period of years. If you wish, the trust also can pay an income to another beneficiary of your choice. At the death of the surviving beneficiary, or the earlier end of the Trust term if one is selected, the remaining principal in the trust goes to a charity or charities you specified. The selection of charities can be changed during your lifetime and at death, and you might also consider naming a family foundation is the charitable beneficiary after death. You can design your trust to fit your own special needs.

First, you decide how much you'd like to put into the trust. Second, you determine the income you'd like to receive from the donated assets. The rate of income return you select must be at least 5 percent. Usually, the rate selected is between 5 percent to 10 percent. The best rate for you will depend upon the number of income beneficiaries, and their ages. Third, you determine how long the Trust (and your retained income stream) will last, and finally, you decide which type of charitable remainder trust will work best for you.

Choosing a charitable remainder trust is a little like shopping for a new car-the right one depends on your personal needs. Luckily, CRTs come in five variations. We can help you consider and decide the method that will work best for you.

Annuity trust: Pays you a fixed dollar amount.

Standard unitrust: Pays you an amount equal to a fixed percentage of the net fair market value of the trust assets as recalculated yearly.

Net income with makeup unitrust: The trust pays the lesser of the fixed percentage specified by the trust agreement or the actual trust income. Such trusts provide, however, that in any year the trust income exceeds the fixed percentage payout, the excess must be used to make up any prior deficiencies. It offers great flexibility in retirement planning, because income can effectively be deferred until later years.

Net income with no makeup unitrust: Pays you the trust's actual income or a fixed percentage of market value (as recalculated yearly), whichever is less. Deficiencies are not made up. This type is used by donors who want to maximize the benefits to the charitable organization.

Flip unitrust: Set up as either of the last two types, this trust converts to a standard unitrust on a triggering event, such as the sale of an "unmarketable" asset used to fund the trust.

Which Is Better: Annuity Trust or Unitrust?

Whether you choose an annuity trust or a unitrust depends primarily on your economic outlook. With an annuity trust, you receive the same fixed amount each year that you chose at the beginning. This is advantageous when you want to be certain of the dollars you'll receive. If you're concerned about the possibility of recessionary times and falling market values, the annuity trust has greater appeal. Although you can't add to this annuity trust later in order to increase your income, you can always create a new trust for that purpose.

In comparison, a unitrust may be a hedge against inflation. If you foresee economic growth resulting in appreciation of the trust's assets, you'll favor a unitrust. The valuation can rise or fall, but over time a well-managed unitrust may offer better protection of your purchasing power than fixed dollar payments. A further advantage is that if you want to enlarge the trust later, you can make additional contributions without the cost of creating and administering more than one trust.

Income and Estate Tax Benefits

Now look at the major and wide-ranging tax savings you can realize when you create a charitable remainder trust.

First, when you fund the trust, you immediately obtain the benefit of a sizable income tax charitable deduction. This is equal to the present value of the remainder interest ultimately payable to your charity, based on Internal Revenue Service tables of life expectancy factors. The older the beneficiary, and the lower the paid out income percentage, the greater the charitable deduction.

You can fund your charitable remainder trust with cash, securities, real estate, or other property. Highly appreciated assets that generate low current income are an ideal funding medium. While you'd be reluctant to sell such assets directly because of the tax you would pay on the gain, you can transfer them to the trust without incurring the capital gains tax. The trust could sell the assets without incurring any tax and then reinvest the proceeds in order to secure a higher current income yield.

Perhaps over the years your personal investments have grown handsomely, but you now realize that their yield is grossly inadequate. Unfortunately, if you sell and reinvest in higher yielding securities, you'll lose a large part of your gain to taxes.

The answer? Transfer your appreciated securities to a charitable remainder trust. In return for your gift, you might get an income two to four times greater than the current dividend from the typical growth stock.

> **Example:** *Elizabeth, aged 75, owns several stocks with a market value of $100,000, but they pay dividends of only $2,000 a year, or 2 percent of market value. She decides to transfer these securities to a charitable remainder annuity trust that will pay her $7,000 a year, increasing her gross income by $5,000.*

If Elizabeth sold her stocks instead, she would pay an enormous tax on her capital gain. Their cost basis is $30,000, compared to the current market value of $100,000, resulting in a gain of $70,000. At a federal capital gains tax rate of 15 percent, the tax would be $10,500. This would leave her with only $89,500 to reinvest, so she would have to find stocks that pay a dividend of more than 8 percent to receive the same $7,000 her trust can pay her.

Even More Tax Advantages

The tax benefits of a charitable remainder trust don't stop with the charitable deduction and reduction of capital gains tax. You can enjoy other tax advantages, too.

Taxation of annual payments. This depends on what type of income your trust earned during the year (or what was undistributed from prior years). Each payment is treated first as ordinary income to the extent of the trust's ordinary income; second, as capital gains to the extent of the trust's capital gains; third, as tax-exempt income to the extent of the trust's tax-exempt income; and last, as a tax-free return of principal.

Investment policies and performance, as well as the type of trust (annuity trust or unitrust), will determine the taxation of the annual payments. The point is, part of your income may be treated as capital gains or may even be tax-free. The trustee will tell you what to report, so you don't have to figure this out yourself. And, you may have some ability to determine the type of income y ou will realize depending on how the Trust assets are directed to be invested from time to time.

If you want to receive tax-free income, you can deposit or direct the purchase of tax-exempt securities, assuming they meet with the trustee's approval for retention by the trust. Note also that the trust instrument may not require that other kinds of transferred property be converted into tax-exempt securities, or that only tax-exempt investments may be made by the trust.

Estate tax savings. If you are the only income beneficiary, your charitable remainder trust will be free from federal estate tax. Because of the marital deduction, this is also true if your spouse is a U.S. citizen and the only surviving income beneficiary.

If the surviving beneficiary is named that is not your spouse, the life interest of the survivor may be subject to tax, depending on the size of your estate and the available tax benefits remaining in your estate. The value of the survivor's interest is based on that individual's age at your death. But the charitable contribution of the remaining principal, made on a survivor's death, is always tax deductible.

Who Can Benefit? Some Typical Cases

You may wonder if your circumstances match those of others who decided to create a charitable remainder trust. In fact, people of widely varying ages and financial situations do benefit, as these examples illustrate:

- **An individual nearing retirement.** You may have personal investments that are highly appreciated, yet have a low yield. By using these assets to fund a unitrust or annuity trust, you can avoid the capital gains tax trap and supplement your income from a qualified retirement plan.

- **A retired couple or individual between ages 60 and 75.** If you have a healthy life expectancy, over a longer term a unitrust can provide a hedge against inflation, assuming the trust investments benefit from a gradually increasing market value that exceeds the usual periodic downturns.

- **An individual over age 75.** For you, an annuity trust has a special appeal. You may be more concerned about receiving a fixed and unchangeable income payment than beating long-term inflation.

- **A single person over age 80.** You might find that a unitrust with a term of 20 years is attractive. The payout balance of the term extending beyond your lifetime can be distributed to your children, grandchildren or anyone you designate.

- **Someone supporting an elderly parent.** You may be seeking a good way to increase a parent's income and also make a philanthropic contribution. A charitable remainder trust can accomplish both objectives.

- **A younger person or couple with little Retirement Savings.** If you have highly appreciated assets you want to sell, but would like to defer or avoid income taxes and accumulate income to withdraw at a later time (such as at retirement) a flip unitrust might be an ideal planning technique.

These are only a few of the many ways a charitable remainder trust can help you supplement other sources of income while providing exceptional tax benefits.

Choosing the Payout Size

As noted earlier, the tax law sets the minimum size of the annual payments to the income beneficiary of a charitable remainder trust.

For an annuity trust, the fixed dollar amount must be at least 5 percent of its initial net fair market value. For a unitrust, the fixed percentage generally must be at least 5 percent of the trust's net fair market value, as determined each year. You may also choose from three unitrust variations: "net income with makeup," "net income without makeup" and "flip." Each of these has unique advantages in different situations.

Is there any upper limit on the amount or percentage? A charitable remainder trust must have a payout rate limited to a maximum of 50 percent, and it must have a charitable remainder value of at least 10 percent of the value contributed to the trust.

You probably would like to receive a higher payout than you could obtain from other investments. That's understandable. But the payout should reflect a reasonable expectation of the trust's total return, which is its investment performance as measured by price changes and Reinvested earnings.

If the payout size is larger than the trust's total return in future years, the trust's principal will gradually erode, reducing the charitable remainder. The U.S. Treasury rules base the value of the charitable remainder on the payout rate, so the higher the payout, the smaller the charitable value. And, of course, the smaller your anticipated contribution to our future needs. Despite these considerations, you will be pleasantly surprised to see how a charitable remainder trust can increase your income from low-yield investments.

Now Add Up Your Benefits

Unlike other ways of contributing to a charity during lifetime, a charitable remainder trust allows you to keep the benefits of the donated assets for life, knowing you'll help to shape the future through your generosity to specified charities at a later date. Some of the personal benefits you can enjoy with this strategy:

- Increase your income when you give to a trust designed to pay out more than you now earn on the assets you will contribute.
- Receive a money-saving federal income tax charitable deduction.
- Pay no capital gains tax when you transfer unencumbered appreciated assets to the trust.
- Free yourself from investment worries if you wish to obtain professional management of the assets you give.
- Have the enduring satisfaction of having made a major commitment to important charitable work.

Design Your Own Life Income Plan

If you're looking for an advantageous way to benefit you now and help your charities later, a charitable remainder trust may be an ideal solution. With the counsel of your legal and tax advisors, a charitable remainder trust can likely be tailored to your personal circumstances.

The information contained herein is not intended as legal, tax or investment advice. For such advice, please consult an attorney, tax professional or investment professional.