

Charitable Trusts: Powering Your Giving

By Phil Keenan

Of all the charitable trusts, one of the most popular is the Charitable Remainder Trust (CRT). This popularity is a result of a multitude of positive factors, including 1) an immediate charitable deduction to the donor at the time of the gift to the trust; 2) the deferral of any taxes on the sale of assets by the trust; 3) the payment of a cash stream to the donor or other non-charitable beneficiaries for either a period of years or for their life; and 4) at the termination of the trust, all remaining assets are distributed to the selected charity.

As with all charitable trusts, the IRS has strict conditions which must be met for the trust to qualify for favorable charitable trust tax treatment. For a CRT, it must be an irrevocable trust which the donor may not modify, although the donor may retain the power to change the charitable beneficiary. The trust must distribute a fixed amount or a fixed percentage of the assets of the trust each year, and that percentage must be between five and 50 percent of the total value of the trust. At the termination of the trust, the remainder to be transferred to charity must equal at least 10 percent of the present value of the assets initially transferred to the trust.

The payout amount to the non-charitable beneficiary(ies) can be computed in two different ways. One choice is to design the trust to pay a fixed amount each year which is calculated at the creation of the trust by multiplying the initial gift by the payout percentage. As an example, a trust which receives a \$1,000,000 gift and has a 5 percent payout will distribute \$50,000 each year to the non-charitable beneficiary. This is known as a Charitable Remainder Annuity Trust (CRAT). Many people like the security of knowing that the payout will be the same year after year.

The other option is for the payout amount to be recalculated every year by multiplying the value of the assets on the first day of the year by the payout



percentage. As the assets of the trust grow and payouts are made, the value of the trust corpus will vary from year to year, as will the payout. With a payout computed in this manner, the donor will receive a higher payout as they share in any growth of trust corpus, but the donor can also receive less if the value of the corpus declines. A trust with this type of fixed percentage payout is called a Charitable Remainder Unitrust (CRUT).

If the trust qualifies as a charitable trust, different income tax rules apply. A charitable trust pays no income tax, so if an appreciated asset is transferred to the trust, the trust will pay no tax when the asset is sold. But the tax is not totally avoided, it is only delayed. When funds are distributed to the non-charitable beneficiaries, they will pay tax on the amount distributed. This delay is a significant advantage. Suppose a donor gives an asset valued at \$1,000,000 to a CRT, and that asset's basis is \$100,000. If the asset was sold outside of the trust, the capital gains tax could be as high as 20 percent, meaning that a tax of \$180,000 would be paid and only \$820,000 would be available to invest. But with the sale occurring inside the CRT, there is no immediate tax, and the entire \$1,000,000 is available to be invested.

But remember, the tax was not avoided, it was only delayed. Given the above example, if the non-charitable beneficiary received \$50,000 from the CRT in year one, the beneficiary would be responsible for paying the delayed capital gains tax on the distribution. They would pay that tax when they filed their personal income tax return. The non-charitable beneficiary will receive a tax form from the trust at the end of the year telling them how much taxable income from the trust they must report.

The donor's charitable deduction is calculated by computing the present value of the remainder interest which will pass to the charity at trust termination. The factors which are included in the calculation are 1) the value of the gift on the day it is made; 2) the value of the annual payout percentage; 3) the number of years the payouts will be made for (if the trust will pay for a specific number of years); and 4) the age of the donor(s) of the trust will pay (if the trust will pay over a lifetime). The calculation uses an estimated rate of return provided by the IRS to compute the present value of the remainder which will pass to charity.

Let's look at a practical application of a CRT. Jim and Jane Smith have a \$1,000,000 block of stock with a basis

of \$50,000. Jim and Jane are both 65 and they would like to diversify that stock without paying a big tax bill. They don't need the proceeds immediately, but would like to receive a cash payment each year for the rest of their lives. At their death, they would like to make a charitable gift to benefit their favorite charity.

Jim and Jane create a CRUT that will pay Jim seven-and-a-half percent of the trust corpus each year for life and, if Jim dies, those payments will be made to Jane for the rest of her life. When they are both gone, any funds left in the CRUT will pass to their favorite charity. They then gift the \$1,000,000 in stock to the CRUT.

If that gift were made today, they would receive a tax deduction for their charitable contribution of just over \$202,000. The

trust would distribute \$75,000 to Jim in the first year. If the trust's investments earned five percent each year and Jim and Jane lived until their life expectancy of 87, the trust would have paid them approximately \$1,267,000 over those 22 years. Following their deaths, approximately \$558,000 would pass to the charity.

If Jim and Jane wished to take the maximum amount allowed out of the trust, the payout rate could be increased to a maximum of 11.2 percent. In this case, the charitable deduction would be \$100,000 and the first payout to Jim would be \$112,000. The trust would have paid them approximately \$1,343,400 over the 22 years they survived. Following their deaths, approximately \$234,000 would pass to the charity.

In the right situation, a Charitable Remainder Trust is an extremely effective planning tool for donors seeking to delay taxes, retain an income stream for life, and benefit their favorite charity.

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