CHAPTER 43

Charitable Remainder Trusts (How to Benefit Yourself and Others)

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WHAT IS A CHARITABLE REMAINDER TRUST?

A Charitable Remainder Trust (CRT) is a way you can donate to your favorite cause while benefiting yourself and your family. It is a powerful income tax and estate tax planning tool that can:

- Defer capital gains taxes on the sale of appreciated assets;
- Provide you with a new source of income;
- Provide you a substantial current income tax charitable deduction; and
- Provide you future estate tax deductions.

A CRT delivers best results when you have a highly appreciated asset — such as real estate or stocks — that provide little or no income. Owning such assets is a double-edged sword. You cannot sell the assets without experiencing the costly bite of state and federal capital gains taxes. On the other hand, if the asset is still in your estate when you die, it will increase your estate taxes. Of course, you could donate the asset directly to charity and gain an immediate income tax charitable deduction. This would reduce the value of your estate — and thus future estate taxes — as well as avoid capital gains taxes, but you miss out on any income the asset could generate. The CRT neatly overcomes these problems.

HOW DOES A CRT WORK?

Step 1

You and your estate planning attorney create a CRT. You, or whomever you designate, is designated as trustee of the CRT so you can remain in control of the CRT's investment decisions. The terms of the CRT provide that it will pay you an income stream (more about this later!) based on either a certain term of years (not to exceed 20) or over one or more lifetimes (whichever you choose to meet your needs). The CRT also provides that whenever the term or lifetimes are over, the remaining trust assets, if any, will go to a charity or charities of your choosing.

Step 2

You transfer a highly appreciated asset that you cannot afford to sell because of potential income taxes to the CRT in return for the trust's obligation to provide you with an income stream over the term or lifetimes you choose, in an amount that is actuarially computed using the expected length of the income stream and the expected earnings rate. The annual income stream cannot be less than 5% of the asset's value and may range upward to as high as 50% depending on the term over which you have chosen to be paid and the prevailing interest rate.

Step 3

The CRT sells the appreciated asset but pays no tax because of its favorable tax status.

Step 4

The CRT, from its liquid resources provided by the sale, pays you an income stream for the term or lifetimes you have designated.

Step 5

After the term for which the CRT is obligated to pay you is over, it distributes any remaining assets to the charities you have designated and the CRT terminates.

SO, HOW MUCH IS MY INCOME STREAM?

Your income stream from the CRT depends on how you choose to be paid. You may choose to have the CRT pay you a fixed annuity that equals a percentage of the fair market value of the assets transferred to the CRT, or you may choose to have the CRT pay you a percentage of the fair market value of the CRT's assets as they are revalued annually.

Conservative investors who want a predictable income year after year may prefer the Charitable Remainder Annuity Trust — or CRAT for short. A CRAT will provide you a fixed annual income regardless of the investment performance of its assets. Because your tax deductions and income are based on the value of the asset as of the day it is transferred to the Trust, the CRAT is probably better suited if you suspect the CRAT's assets may lose value in the years ahead.

Regardless of the economic winds, your income is fixed. So, if the CRAT's assets do not earn enough to pay your annual income, more principal will be used to make up the difference. On the other hand, if the markets turn bullish and the CRAT's assets outperform your expectations, the surplus will be added to the principal and ultimately benefit your charities.

The chief drawback of the CRAT is also its strength; it protects you against swings in the financial markets. Thus, in a stagnant or declining market, you come out ahead. However, in a strong market experiencing investment growth, the charity will ultimately benefit the most. That's why you may prefer the Charitable Remainder Unitrust if you hold more bullish views on investing.

A CRUT offers a couple of advantages over the CRAT. First, unlike the CRAT, you may make as many contributions as you like. And for the sake of determining annual income, it is the asset's current fair market value (revalued annually), not its value on the date it was transferred to the CRUT, which is used in the calculations.

As for its income opportunities, the CRUT allows you to ride the financial markets and enjoy the investment performance of the CRUT's assets. That means, of course, that in some years you may receive less, in other years more. When lean years keep you from receiving your full due, a "make-up provision" can allow for additional income in future years to make up for the shortfall.

A CRUT requires you to receive a minimum income of 5% of the asset's current fair market value, and not more than 50%. You can also opt to receive your chosen percentage or the trust's net income, whichever is less.

An example may help you understand the confluence of your income tax charitable deduction, estate tax charitable deduction, and income stream.

ASSUME:

- You and your spouse are both 70 years old.
- You own a non-income-producing farm with a $10,000 tax basis that is worth $1 million today.
- You would like to generate some retirement cash flow from the farm for both you and your spouse.
- You have a taxable estate.
- You can earn 5% income on invested assets.
- You have identified the farm as an underperforming asset that you want to re-deploy.

The chart below compares alternative courses of action you may take regarding the farm.

	DO NOTHING	YOU SELL FARM AND REINVEST NET PROCEEDS @ 5%	ESTABLISH CRAT AND THEN CRAT SELLS FARM	ESTABLISH CRUT AND THEN CRUT SELLS FARM
Your income stream after sale	$0	$40,100[1]	$60,280[2]	$143,710[3]
Your income tax charitable deduction	$0	$0	$263,565	$100,010
Net value inherited by your heirs	$550,000[4]	$441,100[5]	$0[6]	$0

The chart demonstrates that you can significantly increase your cash flow and also receive a significant income tax charitable deduction. However, your family receives no part of the farm, so they have, in fact, lost $550,000 of their expected inheritance. How can we remedy this for them? By taking a portion of the excess cash flow from the CRAT or CRUT and buying $550,000 of life insurance in an Irrevocable Life Insurance Trust that will not be subject to estate tax at your death.

DID YOU KNOW YOU CAN ALSO USE A CRUT AS AN ANCILLARY RETIREMENT PLAN?

Imagine, instead of the example above, that you are a 50 year old couple who have maxed out their retirement contributions and would to like to put more aside for retirement. How can we do this using a CRUT?

Bear with me — to understand how this works, you need to know about some options that can be built into a CRUT.

As we have seen, the standard CRUT pays you (or whomever you wish to designate) an amount determined by multiplying a fixed percentage of the net fair market value (FMV) of the trust assets, valued each year. On the death of the last beneficiary (or at the end of the trust term if the income term is measured by a term of years), the charity gets the remainder.

You may, however, construct a CRUT that pays only the trust's income if the actual income is less than the stated percentage multiplied by the trust's FMV. Deficiencies in distributions (i.e., when the CRUT income is less than the stated percentage) are made up in later years, when and if the trust income exceeds the stated percentage. This type of trust is called a Net Income Makeup Charitable Remainder Unitrust (NIMCRUT).

So assume you placed the above farm into a NIMCRUT at age 50. The NIMCRUT just holds the farm until you retire at age 65, and then it sells the farm. If the farm appreciates at 8% per year, it will be worth about $2,937,194 in 15 years.

During the intervening years, before the farm is sold, the NIMCRUT will not make any distributions to you because its net income is zero, and therefore less than the 6.864% computed for the standard CRUT. In the fifteenth year, when you retire (or really any time you choose), the farm is sold, creating a capital gain of 2,927,194 ($2,937,194-10,000)[7]. Now the trust can start making up payments to you that were skipped in earlier years when the NIMCRUT had no income. So in year 15 you receive $1,863,721 to "make up" for prior distributions not made and then you start receiving a unitrust amount that starts at $53,674.

What if you don't need the large make-up distribution? What if, instead, we had the NIMCRUT convert into a standard CRUT upon the sale of the farm? This is known as a FLIP-CRUT. In this case, the percentage is recalculated on the increased amount in the CRUT ($2,937,194) and results in an initial payment of $201,609.

SUMMARY

As you can see from our few examples, the CRT is a very flexible and powerful income tax and estate tax planning tool. Using it in your arsenal of tax planning techniques can truly benefit you while doing good for others.

Our mission is to honor and serve God by loving and protecting families. We do this by managing client risk through asset protection, estate, and VA and Medicaid benefit planning.

1. Net proceeds after 20% capital gains tax (1,000,000 -($1,000,000-10,000) x 20%)) invested at 5%.
2. This same payment is made for every year of you and your spouse's joint lifetime (21.8 years under current life expectancy tables).
3. This is the first year's payment — each subsequent payment will equal 14.371% of the balance at the end of the previous year.
4. $1,000,000 asset value less $450,000 estate tax.
5. $802,000 after income tax value less $360,900 estate tax.
6. The assets of the CRAT or CRUT are excluded from your estate and revert to the charitable beneficiary.
7. $3,172,159 sales price less $10,000 basis in the farm.