

Charitable Remainder Trusts

WEALTH TRANSFER

AN INGENIOUS SOLUTION TO A DIFFICULT PROBLEM

You have real estate, stock, or other assets that have increased substantially in value but are not producing an income stream. You would like to sell these assets to reallocate your holdings, but if you do, you will be faced with significant capital gains tax.

Have you considered a charitable remainder trust?

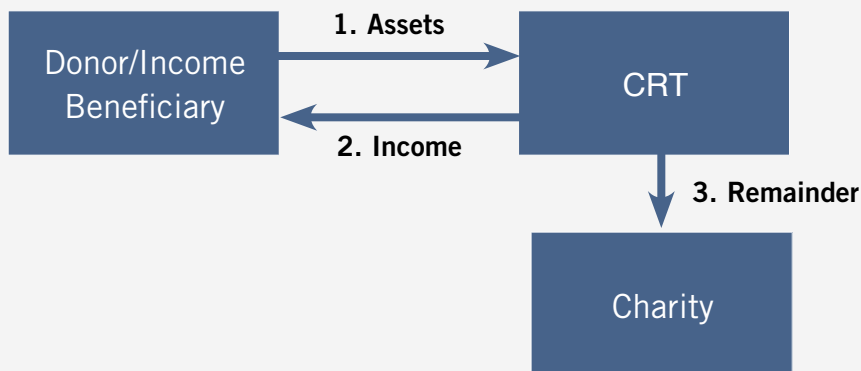
With a charitable remainder trust, you can:

- ▶ Help support your favorite charity
- ▶ Transfer assets without incurring capital gains tax
- ▶ Achieve a substantial income tax deduction
- ▶ Receive an income stream for life or a set period of years
- ▶ Avoid the estate tax that will result at your death if you retain these rapidly appreciating assets

HOW CHARITABLE REMAINDER TRUSTS WORK

A charitable remainder trust (CRT) is a form of irrevocable trust. You create a CRT by transferring cash or other assets to an irrevocable trust. The trust agreement provides that you or a specified beneficiary will receive payments from the trust for a term of years or for the rest of your life. At the termination of this income interest, the assets in the trust are transferred to the charity or charities you have named in the trust agreement.

This diagram gives you a quick overview of the relationships involving the donor/grantor, the trust, the income beneficiary, and the charity:



INVESTMENT AND INSURANCE PRODUCTS ARE:

- NOT FDIC INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT A DEPOSIT OR OTHER OBLIGATION OF, OR GUARANTEED BY, ANY BANK OR ITS AFFILIATES
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TYPES OF CHARITABLE REMAINDER TRUSTS

Charitable remainder trusts are generally structured as follows:

- ▶ **CHARITABLE REMAINDER ANNUITY TRUST (CRAT).** A CRAT is an irrevocable trust that names a charity as a remainder beneficiary and pays a fixed amount or annuity to the named income beneficiaries for a specified period of time.

Because the increases (or decreases) in the value of the assets in the trust do not affect the income payments, the income beneficiaries are assured of a more stable income stream than with a charitable remainder unitrust.

- ▶ **CHARITABLE REMAINDER UNITRUST (CRUT).** A CRUT is an irrevocable trust that provides the named income beneficiaries with the right to a fixed percentage of the value of the trust assets, as valued annually.

The CRUT provides a potential hedge against inflation by allowing the income stream to increase if the trust assets appreciate. However, there is no guarantee, and the payout may decline where assets do not perform.

In addition to the standard fixed percentage unitrust discussed above, CRUTs are often structured with some additional payout options:

- **Net-Income Unitrust or NI-CRUT.** This CRUT pays the lesser of a fixed percentage of the annual value of the trust assets or the trust's actual annual income.
- **Net Income with Makeup or NIM-CRUT.** Similar to the NI-CRUT, the NIM-CRUT provides for an annual payout that is the lesser of a fixed percentage or trust income. However, to the extent that the trust earns income in future years that exceeds the specified CRUT percentage, excess earnings are used to make up for any payments that were less than the CRUT percentage in prior years.
- **Flip Unitrust.** Allows a net income unitrust to "flip," or change, to a standard unitrust upon a triggering event.

Financial professionals often use a flip CRUT or a net-income limitation in two situations:

- Under circumstances when it may be difficult to meet the annual payout requirements because the donated asset may not be liquid and may take time to sell (e.g., real estate or stock)
- Where a donor has no current need for income but will in the future

WHAT DETERMINES THE TAX BENEFITS?

The tax benefits of a charitable remainder trust are a function of many factors, including:

- ▶ Value of the donated assets
- ▶ Duration of the trust
- ▶ Type of trust (annuity or unitrust)
- ▶ Charitable payout rate
- ▶ Federal discount rate imposed by IRC Section 7520, which changes monthly

THE ADVANTAGES OF A CRT

In addition to the income stream paid to the donors or named beneficiaries, some of the advantages of a CRT include:

- ▶ A CRT may be established during the donor's lifetime or at their death.
- ▶ The donor can choose a fixed stream of income (CRAT) or a variable payout (CRUT).
- ▶ Appreciating assets can be transferred out of the estate without triggering capital gains tax.
- ▶ When the CRT sells appreciated assets, dollars are not lost to capital gains tax, ensuring that additional sums accumulate for the benefit of the charity or the income recipients.
- ▶ The donor can work with their advisors to maximize the charitable deduction or the income stream within the guidelines dictated by the Internal Revenue Code.
- ▶ The donor or their estate receives a charitable deduction for the value of the remainder interest.

DETERMINING THE DONOR'S CHARITABLE INCOME TAX DEDUCTION

Lifetime gifts. The present value of the charity's remainder interest is "potentially" deductible for federal income tax purposes. The actual amount that can be deducted is dependent on a number of factors.

There is a limit on the amount that may be deducted for charitable purposes, based on the donor's adjusted gross income (AGI). Annual charitable contributions can never exceed 60%¹ of the AGI and may be limited to a lower percentage depending on the type of property donated and the nature of the recipient charity.

This chart shows how these factors can affect your annual charitable income tax deduction:

DEDUCTION LIMITATIONS			
Property Donated			
Donation Made To	Cash	Ordinary Income	Capital Gains Property
Public Charity	60.00%	50.00%	30.00%
Private Charity	30.00%	30.00%	20.00%

If the amount of the charitable contribution(s) exceeds these deduction maximums in the year of the donation, the excess amounts can be carried over and used for up to five additional years.

In addition, tax laws limit the amount of itemized deductions that are allowed to high-income individuals. In some cases, this may restrict a donor's ability to use the full amount of a charitable deduction to offset taxable income.

¹Beginning Jan. 1, 2026, the limit on the amount that can be deducted for cash contributions will be reduced to 50%, per the current tax code.

THE DISADVANTAGES OF A CRT

There are two major disadvantages to a CRT:

- ▶ The trust must be irrevocable. It's important that you seek the advice of your legal and tax counsel prior to implementing a CRT.
- ▶ When the trust terminates, the assets pass to charity, not to family members.

While the charitable remainder trust offers many benefits, this strategy can effectively disinherit your heirs. One effective solution to overcoming this disadvantage is a wealth replacement trust.

CASE STUDY—WITH THE BASICS IN PLACE, LET'S ADD SOME NUMBERS

Mr. Smith has his attorney create a 20-year charitable remainder unitrust funded with appreciating real estate worth \$1 million. The CRT pays an annuity of 5% of the trust's value to Mr. Smith for 20 years. At the end of this income period, all assets remaining in the trust pass to Mr. Smith's alma mater.

The present value of the income stream going to Mr. Smith is worth approximately \$636,278.¹ Mr. Smith is deemed to have made a charitable gift of the remainder interest of approximately \$363,722 (\$1,000,000 less \$636,278). He will get a current income tax deduction for this amount, subject to limitations, based on his adjusted gross income and the phase-out of itemized deductions applicable to higher-income taxpayers.

If the assets in the trust grow by 5% over the 20-year period, the trust principal passing to the charity will continue to be just under \$1 million.

As you can see, a charitable remainder trust is an excellent way to move rapidly appreciating assets out of an estate with tax efficiency, ensure that you and your spouse have a stream of income, and provide a significant gift to your alma mater, church, or other favorite charity.

THE WEALTH REPLACEMENT CONCEPT

By directing a portion of the tax savings and/or additional income generated by the CRT to the purchase of a life insurance policy, you can donate your assets to charity and still provide a benefit to your heirs.

You decide how much of the charitable gift to replace. You can buy enough life insurance to replace only a portion of the donated property, or you may prefer to replace all of the gifted property.

The life insurance should be owned outside your taxable estate (i.e., by your children or by an irrevocable life insurance trust (an ILIT)).

If ownership is structured properly, policy proceeds will not be included in your estate at your death. This can mean a larger after-tax inheritance for your heirs than if they received the asset itself.

¹Based on present value calculation assuming a 5.60% Section 7520 rate at time of transfer.

QUESTIONS AND ANSWERS

Q. Can I change my mind about which charity receives the remainder interest in my CRT?

A. With certain restrictions, you can retain the power to change, substitute, or designate a new charity after the creation of a CRT.

Q. Can any charity be named the remainder beneficiary of the CRT?

A. The charity must be “qualified” under the Internal Revenue Code or the donation may not be tax-deductible. Donors can use the IRS website and Publication 78 to check whether an organization is qualified.

Q. Is there a time limit for the income term of a CRT?

A. The term of a CRT can be for a set duration not to exceed 20 years or an individual’s lifetime.

Q. Can I structure the income stream as high as I want to meet my income needs and still get an income tax deduction?

A. No, the income stream cannot be less than 5% or more than 50% of the initial net fair market value of the CRT assets. In addition, the charity’s actuarial interest must be at least 10% of the initial fair market value of the assets transferred to the trust. For a CRUT only, if the mathematical probability of exhausting the asset (leaving nothing for the charity) is higher than 5%, no income or estate tax deduction is allowed.

Q. Can I make multiple contributions to a CRT?

A. To a CRUT, yes; a CRAT cannot accept additional donations.

Q. Are income beneficiaries taxed on the income they receive?

A. Distributions are taxed to the income beneficiaries under a “four-tier” priority system with the highest taxed income paid out first.

Q. Can I name anyone as an income beneficiary?

A. Yes, but if the income stream is paid to someone other than the donor or the donor’s spouse, gift taxes and generation-skipping transfer taxes may be incurred.

IN SUMMARY

Charitable remainder trusts can be both a rewarding experience and a strategic tool allowing you, the donor, to both give and receive. If you believe that a CRT may be right for you, contact your financial professional for additional information.

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