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### **CHARITABLE REMAINDER TRUSTS: A TAX-SAVING TOOL FOR THE CHARITABLY INCLINED**

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A charitable remainder trust (“CRT”) is a fairly sophisticated planning tool for those who are charitably inclined and have a need to obtain income, gift and estate tax charitable deductions. Simply put, a CRT is a trust<sup>1</sup> where the property you contribute, plus appreciation and (perhaps) some income, will ultimately go to one or more qualified charitable organizations. In the meantime, during the term of the trust, one or more non-charitable beneficiaries—even you and your spouse—receive certain benefits from the trust property. Besides that “warm and fuzzy” feeling that giving to charity should give, establishing a CRT has many practical and economic benefits, including:

1. Entitling you to an income tax charitable deduction for a portion of the value of the property contributed;
2. Delaying the realization of capital gains tax on the sale of highly appreciated assets (*e.g.* concentrated positions in appreciated stock) while having the benefit of the income stream that the sale and reinvestment of those assets may produce;
3. Facilitating the sale and diversification of concentrated, appreciated stock to reduce investment risk while minimizing the capital gains tax impact;
4. Entitling your estate to an estate tax deduction for the property passing to charitable organizations;
5. Providing a set way of giving one or more non-charitable beneficiaries (*e.g.* children) a series of payments over a period of time; and
6. Establishing a method of managing and safeguarding assets within a trust, with accountability to—but not control by—the beneficiaries.

This memorandum is intended to provide those considering establishing a CRT with some introductory information before proceeding with an attorney to discuss whether a CRT fits into your overall estate plan. Other important team members in

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<sup>1</sup> A trust is a contract between the person establishing the trust (called the “Grantor,” “Settlor,” or “Trustor”) and the person charged with administering the trust, the trustee, to hold property according to the instructions in the document for the benefit of one or more beneficiaries.

considering a CRT will be your accountant, your financial advisor, and (possibly) the representative from the charitable organization to which you intend to provide a benefit.

### **Types of CRTs.**

There are two general types of CRTs: the Charitable Remainder Unitrust (“CRUT”) and the Charitable Remainder Annuity Trust (“CRAT”). The difference between these two types of CRTs has to do with the method by which the payment to the non-charitable beneficiary(ies) is determined. With a CRUT, the non-charitable beneficiary receives a periodic amount that represents a set percentage (regardless of income) of the value of the property held in trust. (Example: the non-charitable beneficiary(ies) receives an amount equal to 4% of the value of the CRUT property each year). With a CRAT, the non-charitable beneficiary receives a fixed dollar amount periodically.

Choosing the type of CRT appropriate for you is a decision that depends partly on personal preference, including your overall goals regarding the non-charitable beneficiary(ies), and partly on the nature of the assets you plan to contribute a CRT. There are some very technical nuances within these two general types of CRTs that can be utilized to take into account different situations. For example, let’s say you plan to contribute assets that are not readily marketable, like real estate or closely held stock. Obviously, a requirement to make a set payment to the non-charitable beneficiary may require the sale of that trust property at a time when that is not possible, practical or prudent. However, a CRT may anticipate this situation by deferring or delaying the payment to the non-charitable beneficiary until it is prudent to sell all or part of the property owned by the trust.

### **Income Tax Deductions.**

One of the primary benefits of a CRT is that the creator gets to use some very significant income tax deductions. Charitable income tax deductions are limited to a certain percentage of your adjusted gross income (“AGI”). The AGI percentage limitation varies depending on the type of charitable organization to which the contribution is ultimately passing, as well as the type of property being contributed. Further, within the AGI limits, with certain types of property you may deduct the fair market value of the property, and with other types of property, that deduction is limited to your basis<sup>2</sup> in that property. Below is a summary of the AGI limits and the methods of valuing the deduction based on the types of property donated, and based on the type of organization receiving the property.

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<sup>2</sup> “Basis” is a concept used in determining income tax capital gain or loss. Generally, your basis in a property is what you paid for it, plus any improvements, less any depreciation. For example, if you purchase a stock for \$40,000 (your “basis”), then sell it for \$60,000, the difference between your basis and the selling price would be subject to capital gains tax. Note that if you give property away, the recipient takes whatever your basis was in that property; however, until 2010, if you die owning a property, your beneficiaries or heirs will generally receive a “step up” in basis to the fair market value of the property upon your death.

	Private Foundation <sup>3</sup>		Public Charity <sup>4</sup>	
	AGI Limit	Deduction	AGI Limit	Deduction
Cash/Cash Equivalents	30%	FMV*	50%	FMV
Appreciate Publicly Traded Stock	20%	FMV	30%	FMV
Other Long Term Gain Property	20%	Basis*	30%	FMV
Ordinary Income Property (ex: inventory)	30%	Basis	50%	Basis
Tangible Personal Property (unrelated to exempt function)	30%	Basis	50%	Basis
Tangible Personal Property (related to exempt function—ex: art to a museum)	30%	Basis	50%	FMV

\* “FMV” means “fair market value;” “Basis” is explained in footnote 2; where “Basis” is noted, it’s actually the lesser of the basis or fair market value.

If the allowable charitable income tax deduction the year you establish at CRT exceeds your AGI limits, you may carry over the balance of your allowable deduction for five years and use it against future income. Your attorney or accountant can assist you with the very specific requirements for substantiation concerning the valuation of the property you contribute to charity. For those inclined to research these requirements directly, IRS Publication 526, *Charitable Contributions*, and IRS Publication 561, *Determining the Value of Donated Property* may be useful. Both can be found at the IRS website: [www.irs.gov](http://www.irs.gov).

### **Gift and Estate Tax Deductions.**

The value of the portion of your gift to a CRT that benefits the charity qualifies for a gift tax deduction. The portion passing to charity will depend on the term of the trust, which term could be based on the life expectancy (according to the IRS) of the non-charitable beneficiary. The IRS provides tables for calculating the portion of the gift that

<sup>3</sup> A Private Foundation is a charitable organization that receives the majority of its funds from one individual or a family of related individuals. Wealthy families wishing to be involved first-hand in making charitable contributions and in teaching future generations the benefit of philanthropy may consider forming a private foundation. This is not something a family should do on a whim or with a small amount of funding because private foundations can be relatively expensive and time-consuming to form and to maintain.

<sup>4</sup> A Public Charity is a charitable organization that is not a Private Foundation because it receives support from a variety of individuals and entities. Like a Private Foundation, a Public Charity is an organization meeting the requirements of the Internal Revenue Code whereby donations to it are deductible. Before making a donation to either a Private Foundation or a Public Charity, if you question whether or not your donation will be deductible, you should ask for a copy of the organization’s 501(c)(3) determination letter.

passes to the charity and the portion that is retained by you or given by you to non-charitable beneficiaries.

If you choose to give the term or lifetime benefit to a non-charitable beneficiary (rather than keep it yourself), then the value of that portion of the gift is subject to gift tax. Whether you will be required to actually write a check to the IRS for the tax regarding this gift depends on how much of your \$1 million lifetime gift tax exclusion you have used. If you have not used all of your gift tax exclusion, then the portion of the CRT going to the non-charitable beneficiary(ies) will merely use some (or all) that your exclusion. A gift tax return will generally be required for the year that the gift is made.

If you decide that you want to be the lifetime beneficiary, the value of the trust will be included in your estate for the calculation of your estate tax. However, your estate is entitled to a dollar-for-dollar charitable deduction for the value of the charitable remainder interest. If you are married and you and your spouse are the lifetime beneficiaries of the trust, then upon the first spouse's death, a marital deduction will generally defer estate taxation of the trust. Then, upon the second spouse's death, assuming there are no further non-charitable beneficiaries, the charitable deduction will generally cover amounts ultimately passing to the charitable beneficiary(ies).

The distinction shown above in the income tax section regarding gifts to Private Foundations versus gifts to Public Charities does not apply regarding gift and estate tax deductions. Gifts or testamentary bequests to both types of charitable organizations will qualify for gift or estate tax deductions.

### **Capital Gain Tax Benefits.**

CRTs are generally exempt for capital gains tax. Accordingly, CRTs can be very useful in situations where you own highly appreciated assets that are not producing any income and you want/need an income stream, but do not want to realize capital gains tax immediately. Also, you may have a highly concentrated stock position—perhaps due to gift or inheritance or due to the exercise of stock options—and you want to diversify your assets to minimize your market risk, but you want to do so without immediately realizing capital gains tax. If you are charitably inclined anyway, and charity would be part of your estate plan whether you had these tax issues or not, then a CRT may offer a “win-win” situation for you.

Appreciated assets may be sold immediately upon their contribution to the CRT and, so long as the ordinary investment income from the proceeds of the appreciated assets that are sold is sufficient to cover the required periodic payment to the non-charitable beneficiary(ies) (probably yourself), capital gains tax will not be realized and taxed to the CRT. Even if the trust's ordinary investment income does not cover the non-charitable payment and gain property is distributed to the non-charitable beneficiary, gain may be spread out over a period of years, rather than being realized all at once.

## **Requirements and Limitations Regarding CRTs.**

Briefly, below is a list of some of the requirements and limitations of CRTs of which you should be aware:

- CRTs must be irrevocable—you generally cannot change the terms after you sign the document.
- There are time limitations before which the property must pass to the charitable organization(s). For example, a straight term of years cannot exceed 20 years, and even if the term is based on life expectancies—even successive life expectancies—that period of time must be calculated to provide a certain minimum benefit to the charitable organization(s).
- Another trust may not generally be a non-charitable beneficiary, unless the individual whom the trust benefits is incapacitated.
- You cannot limit the trustee's investment authority regarding the realization of a reasonable amount of income or gain.
- You may be the trustee of your CRT, but there will be some limitations regarding some decisions if you are (e.g., you won't be allowed to determine the value of certain difficult-to-value assets).
- A charity may be an income beneficiary, so long as there is at least one non-charitable income beneficiary.
- You cannot fund a CRT with mortgaged property.
- The remainder of a CRT must pass to a charitable organization and you must provide a method for determining a backup charitable organization should the organization you select fail to qualify as a charity.
- No amount other than the annuity or unitrust amount may be paid to anyone other than a charitable organization.

## **Preparing a CRT.**

An attorney experienced with the technical aspects of CRTs can prepare this instrument for you and assist you in the selection of assets, trustees and beneficiaries. As mentioned above, creating a CRT may best be done as a team effort involving your attorney, accountant, financial planner and the charity. Some charitable organizations offer sample forms at no cost. These organizations cannot, however, offer you legal advice regarding the form or whether it suits your needs. They will direct you to your attorney to review these issues with you.

Note that a CRT may be done as an irrevocable trust you create and transfer assets to fund during your lifetime (an “inter vivos” trust), or it may be included in your will or your revocable trust as a trust that does not become effective until your death (a “testamentary” trust). Obviously, if it is done in a manner that is not effective until your death, the income tax benefits will not apply.

### **Conclusion.**

A CRT is not for everyone, however, it should be considered if:

- You are charitably inclined, AND
- You need to reduce the size of your estate for estate tax purposes and you can utilize the income tax charitable deductions within the year of the creation of the trust or within the five-year carry-over period, OR
- You can benefit from the capital gains qualities of a CRT (selling appreciate property to make it produce income; diversification of a concentrated position in appreciated stock), OR
- You want to provide a non-charitable beneficiary with a stream of payments during a certain term or during his or her lifetime, but you are not as interested in passing the balance on to others upon that beneficiary’s death (or the termination of the term).

### **Disclaimers:**

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