

Charitable Remainder Trusts Offer Planning Flexibility

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Practice Area: Estate Planning

Charitable remainder trusts are a popular tax saving alternative for individuals with no children and for individuals and couples who are wealthy enough to benefit both children and charity.

Charitable remainder trusts can also be used to “do well by doing good.” They can be structured to enhance income from investments; diversify low basis, appreciated investments; facilitate the sale of a business in a tax advantaged way; and provide a tax advantaged fund for payment of tuition.

In a charitable remainder trust, one or more individuals (including the grantor, in most cases) receive an annual income for life or for a designated number of years. At the death of the last income beneficiary, or the end of the term of years, the assets are distributed to one or more designated charities. The trust may be created and funded during the life of the grantor, via a trust agreement, or at the death of the grantor, via a will.

There are two basic forms of charitable remainder trusts. A charitable remainder annuity trust (“CRAT”) pays a fixed annual dollar amount to the beneficiaries based on the initial value of the property transferred to the trust. No further transfers may be made to a CRAT trust after the initial gift. Donors who wish to receive a constant, predictable dollar amount usually choose this option.

A charitable remainder unitrust (“CRUT”), on the other hand, pays beneficiaries the lesser of either a percentage of the fair market value of the trust assets or the actual trust income for the year. The fair market value of the CRUT is determined when the trust is created and recalculated each year. Thus, the payment varies from year to year with the current value of the trust assets. Additional gifts may be made to this kind of trust. This option is preferred by those concerned that inflation may erode their income. A charitable remainder trust of either kind is irrevocable and cannot be amended, except to remove or add charities. The grantor may retain the power to revoke the interest of a non-charitable beneficiary.

If carefully drafted, a charitable remainder trust may provide for the grantor (and the grantor’s spouse) to serve as trustee, provided the trustee’s powers are limited to exercising investment authority and paying the annuity or unitrust amount. Usually, however, the trustee is a trust company, bank, charitable organization or unrelated, non-subordinate individual.

Tax Consequences

Income tax. The present value of the trust assets that will pass to charity can be determined actuarially; this amount qualifies for an income tax deduction in the year the property is transferred and for up to five more years if necessary. The deduction is subject to limitations depending on the type of asset placed in the trust – cash, marketable securities, closely held business interest or real estate.

The deduction also depends on whether the charity is public or private. In the case of public charities, the income tax deduction for contributions of cash is limited to 50 percent of the grantor's adjusted gross income. For contributions of appreciated capital gains property, it is limited to 30 percent. Special limitations govern deductions for contributions to private foundations.

Because the ordinary income and capital gains of a charitable remainder trust are exempt from income taxes, annual payments are not reduced by taxes until they reach the hands of the income beneficiaries.

No gift tax. The value of the charitable remainder is not subject to gift tax. If the grantor is the sole non-charitable beneficiary, there is no gift tax on the grantor's income interest. If the grantor's spouse is also a beneficiary, there is no gift tax because of the gift tax marital deduction.

In the case of other beneficiaries, gift tax can be avoided if the grantor reserves the right to revoke the interest by will. If the interest does not begin until after the death of the grantor, it is subject to federal estate tax, although the grantor's \$625,000 applicable exclusion may be applied.

Estate tax. If the grantor is the sole income beneficiary of the charitable trust, there is no estate tax because the interest expires at death. If the grantor's spouse is also a beneficiary and survives the grantor, there is no estate tax because of the marital deduction. In either case, the remainder qualifies for the estate tax charitable deduction.

Planning Opportunities

Increase cash flow. A grantor (individual or couple) who owns low basis marketable securities that have appreciated in value but generate low dividends can increase the cash flow from these investments by transferring them to a charitable remainder trust. The securities are sold by the trustee, incurring no capital gains tax, and the proceeds invested to produce cash flow. The cash flow is distributed to the grantor for life or for a set term of years. At death, the trust assets are distributed to one or more charities.

If the grantors do not need the all of the increased cash flow and wish to benefit family members as well, some or all of this amount can be used to pay premiums on a life insurance policy that will pass to the family at death. The remainder will pass to charity. If the policy is owned by an irrevocable trust rather than the grantors, it escapes estate tax at the grantors' deaths.

Investment diversification. A grantor who has sufficient cash flow from investments, retirement plan benefits or deferred compensation can achieve investment diversification by transferring low basis, highly appreciated shares of a single, publicly traded stock to a charitable remainder trust. The trustee sells the securities, avoiding capital gains tax, and invests the proceeds in a broadly diversified portfolio.

If a charitable remainder unitrust is used, the stock can be transferred over a period of years. Here, too, cash flow can be used to finance an irrevocable life insurance trust, thus replenishing the value that passes to charity at the death of the grantor.

Sale of Business. By transferring a closely held business to a charitable remainder trust and letting the trustee negotiate and close the sale, grantors can avoid capital gains tax on sale proceeds. Proceeds are invested by the trustee in diversified investments that pay a stream of income to beneficiaries – including the former business owner.

Tuition Trust. Parents can contribute appreciated securities to a charitable remainder trust, with the annuity earmarked to pay a child's tuition for four or more years before the remainder passes to charity. Since the income goes to the child, it is taxed at the child's lower tax bracket. The parents receive a current income tax deduction for the remainder that passes to charity.

The gift of the annuity to the child absorbs some of the parents' gift/estate tax exclusion, but removes the entire value of the securities from the taxable estate of the parent. For a tuition trust to be feasible, the parent must be willing to relinquish the income stream of the trust.

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