CRTs - A CHARITABLE IDEA

What do you recommend for the corporate executive, or the elderly client with no liquidity, who holds low basis, high value stock? Your client may want to avoid capital gains tax, remove assets from the taxable estate, provide current or future income for the family, and minimize income tax. Most planning techniques accomplish some but not all of these objectives. Before recommending a sale, gift or other transaction, however, the adviser should consider the benefits of a charitable remainder trust (“CRT”).

In the right circumstances, the CRT (or other “planned giving” techniques beyond the scope of this article) may accomplish all of the objectives and even provide a current income tax deduction, a larger inheritance for all of the intended beneficiaries, and as not marketed, asset protection planning from the client’s potential creditors. So what is it and how does it work?

Definition

A CRT is a trust set up during lifetime or at death which is funded with the client’s assets and provides for distributions to designated beneficiaries for a defined term. At the end of the term, the remaining trust assets are given to charity. Typically the trust will pay income to the individual and/or the individual’s spouse for the rest of their lives, and upon their death the trust is paid to a charity or charities of their choice.

The CRT is defined in the Internal Revenue Code and must include several provisions to accomplish the special gift, income, and estate tax benefits. The IRS has published sample trust documents which can be used as prototypes in designing the trust.

Process

The process of setting up a trust is very similar to the process of establishing a corporation. You must have a trust document, assets need to be transferred to the trustee to be held in the name of the trust for the benefit of the trust beneficiaries, and an income tax return needs to be filed each year. You need to follow the formalities to ensure that the trust is recognized as a separate taxable entity and that it accomplishes your client’s goals.

Types

There are two general types of CRTs which are recognized for tax purposes. The first type is a “charitable remainder annuity trust” (CRAT), which pays a fixed dollar amount at least annually to one or more persons. The second type is a “charitable remainder unitrust (CRUT) which pays a fluctuating annual amount to the beneficiary based on a fixed percentage, which must be at least 5%, of the annual trust value. In one variation of the CRUT, the annual distribution is limited to the lesser of (1) the actual income, (2) or the stated unitrust amount. Planning flexibility can be enhanced by further providing that the income deficiency will be made up in later years when the trust income exceeds the stated unitrust amount. For example, if

the trust beneficiary does not currently need the income, the trustee could invest in growth, rather than income-producing, assets, and then later switch to income-producing assets when the the beneficiary needs the income.

Taxation

The trust itself in most cases is a tax-exempt entity; if it sells highly-appreciated assets, the trust pays no income tax on the appreciation. Income tax is paid only by the beneficiaries if they receive income distributions during the year. If no income is or is required to be distributed, no income tax is currently paid. In addition, th donor escapes the income tax on the capital gains and receives an immediate income tax charitable deduction for the present value of the charity's remainder interest. Once the assets are transferred into the trust, they are no longer considered part of the donor's estate for estate tax or creditor purposes (unless the donor retains an interest in the trust).

Example 1

Assume a client has stock worth $1,000,000 with a tax basis of $10,000. If the stock is sold, the client pays about a 35% capital gains tax (federal and state) of $346,500. If the client instead contributes the stock to a CRT, the client pays no income tax, and in addition gets an income tax charitable deduction for the value of the charity's interest. Table 1 shows a comparison of the charitable deduction the client receives at different ages (the amount of the deduction also varies with the assumed payout rate, and the current interest rates).

The annuity beneficiary, which could be the client, gets an annual payment for life or a term of years based on the percentage chosen by the client (the "payout rate") of the annual CRT value. After the end of the trust term, the remaining assets in the trust go to charity of the client's choice. The client can go even further and use a portion of the annuity payments or the tax savings from the charitable deduction to fund life insurance payable to family members. The insurance replaces the assets placed in the CRT. If the life insurance is properly placed in an irrevocable trust, the proceeds are not included in the client's estate.

Distributions

If distributions are required or made, then the character of the distribution to the recipient for income tax purposes is based on the type of income earned by the trust. Distributions may consist of four parts. The first part is considered ordinary income to the extent the trust had (1) ordinary income during the year or (2) undistributed ordinary income from prior years. If the distribution is larger than the trust's ordinary income, the excess is treated as capital gain income to the extent of the trust's capital gains. The other two parts are "other income" and distribution of principal.

Example 2

Assume a trust has ordinary income of $200, capital gains of $500, and other income of zero during the year. Also assume no undistributed income from prior years. If no distributions are required or made for the current year, the income will not be currently taxed. On the other hand, if we assume that the trust is required to distribute $1,000 to the income beneficiaries, the first $200 will be taxed as ordinary income to the beneficiaries (allocated prorata to each beneficiary based on the portion of the $1,000 each receives). $500 will be taxed as capital gain, and the remaining $300 will be treated as nontaxable distribution of principal.

If there are expenses to be deducted by the trust, the deductions are first directly allocated to the income to which they are attributable. For example, if the trust had $100 of expenses directly attributable to the capital gain above, the net capital gain for distribution purposes would be $400 rather than $500. To the extent there are deductions not directly attributable to a specific income item, the deductions can be allocated in any manner. If the trust above had the $100 of directly attributable expense and another $300 of indirect expenses, the $100 is attributed to the capital gains, and the $300 is attributed to the four categories in the discretion of the trustee.

Tax Returns

All trusts (including CRTs) must adopt a calendar year. The income tax return is filed annually using Form 5227, "Split Trust Information Return" and Form 1041-A, "Trust Accumulation of Charitable Amounts," both due by April 15 (Form 1041-A is not required if all of the income is distributed). The trust also distributes Form 1041, Schedules K-1 to the beneficiaries to report the taxation of income distributed by the trust. A copy of the trust instrument must be included with the first year's Form 5227. The trust must also file Form 1041, "Income Tax Return for Estates and Trusts," if it has any unrelated business taxable income (typically a problem if the contributed assets are debt-financed), and Form 4720 if there are any excise taxes to be paid under the private foundation rules.

Donor Reporting

The donor must file Form 8283, "Noncash Charitable Contributions," with the donor's individual income tax return if the deduction for noncash gifts exceeds $500. An appraisal is required for any noncash (except for publicly-traded securities) contribution deduction which exceeds $5,000. Form 709, "Gift Tax Return," must be filed to report the transfer into the trust if an individual other than the donor or the donor's spouse is designated as a recipient of the annuity or unitrust amount. If the trust is established at death or otherwise includible in the donor's estate, the present value of that individual's interest and the charitable interest are reported on Form 706, "Estate Tax Return."

Conclusion

The CRT is a powerful tax planning tool in the appropriate circumstances. All clients can benefit from the special tax treatment, particularly if they hold highly-appreciated assets. The client should also have charitable intentions, although there may be other motivations which are more important to the client. Depending on the sophistication of the planned giving officer at the charity, you also may be able to get projections and details tailored to your client's situation directly from the intended charity at little or no cost. Do not overlook the benefits of the CRT, or other planned giving techniques, when advising your clients on income or estate tax planning.

Table 1

Contributions to Charitable Remainder Unitrust

	At Age 55	Age 70	Age 70
FMV of Property	1,000,000	1,000,000	1,000,000
Assumed Payout Rate*	6%	6%	8%
Assumed AFR Rate**	8%	8%	8%
Charitable Deduction***	$301,540	$503,220	$413,390

*Chosen by donor
**Applicable federal rate
***Multiple FMV times factor from tables published by the IRS