

SEARLES LAW OFFICE, P.L.C.

Charitable Remainder Trusts (CRT's)

Charitable Remainder Trusts are irrevocable trusts that actually provide for and maintain two classes of beneficiaries: Income beneficiaries (usually the Trustor and spouse or children, if appropriate) and remainder beneficiaries (charities).

Income beneficiaries receive a set percentage of the value of the trust, or a fixed dollar amount annually for their lifetimes or for the term of the trust, if it is limited to a specific number of years. The charity or charities that the Trustor names receive the principal of the trust after the income beneficiaries pass away or the trust terminates.

Maintaining Control

While a CRT is an irrevocable trust, the Trustor (the one who establishes the trust) may change the charitable beneficiaries at any time. Under certain conditions, the Trustor may even serve as trustee of the CRT. As trustee, the Trustor can maintain full investment control of the assets inside the CRT.

Capital Gains Taxes

Because their assets are destined for a charity, Charitable Remainder Trusts do not pay any capital gains taxes. These taxes can be up to 20% of an asset's growth in value for federal capital gains taxes, plus the additional capital gains taxes levied by the state. For this reason, CRTs are ideal for assets like stocks or property with a **low cost basis but high appreciated value**.

For instance, suppose you sell one of your rental properties for \$1 million. Assume that you originally paid \$250,000 for the property. Upon completion of the sale, you would owe capital gains taxes on the \$750,000 difference. That tax could easily top \$150,000, depending on how long you owned the property and your overall tax situation.

Funding a CRT with highly-appreciated assets (like real estate or common stocks) allows you to sell those assets without paying any capital gains taxes. Since CRTs have one or more charitable remainder beneficiaries and do not have to pay capital gains, the entire value of the appreciated asset is the beginning value of the trust, unreduced by capital gains taxes.

Payments to the Income Beneficiaries

The amount of income to be paid out of the CRT depends upon the payout percentage or dollar amount that is chosen, and the amount of income the assets generate while inside the CRT.

The IRS states that, at a very minimum, the CRT must distribute at least 5% of the net fair market value of its assets. If the beneficiaries don't need the full amount in a year, they may elect to defer income through a "makeup provision." However, the CRT's net distributions **must eventually equal 5%** to be considered valid by the IRS.

By letting the CRT grow without taking income from it during the early years, the CRT can begin making payouts to the beneficiaries when they retire. These payouts can include makeups for any shortfalls that were not received in earlier years. Unlike IRAs or 401(k) plans, there are no limits on how much can be contributed to the CRT.

When setting the payout percentage, the Trustor should be aware that the higher the percentage is, the lower the charitable income tax deduction. This is based on the premise that the higher the income interest, the lower the remainder interest that will go to charity.

Income and Estate Taxes

A CRT is considered "outside of your estate" by the IRS. Because of this, the Trustor's estate may end up saving as much as **50 cents of every dollar** which is contributed to the CRT. In addition, the annual gift tax exclusion and the Trustor's unified credit do not limit the amount that can be contributed to the CRT.

Contributions to a CRT, because the trust ultimately benefits charity, qualify for an income tax deduction. The amount of the deduction is the present value of the remainder interest to the charity. This amount is based on the percentage payout selected, life expectancy of the income beneficiaries and/or the term of the trust.

The current income tax deduction also depends on the type of property contributed, as well as the type of charities named as a beneficiaries.

Average deductions normally fall in the range of 10% to 50% against adjusted gross income. Any charitable deduction which can not be used in the year of contribution may be carried forward for the next five years to be used against future years' income.

Although there can be significant estate and income tax savings generated upon the establishment of a CRT, the payments to the income beneficiaries are often subject to income tax upon receipt. The type of income received by the CRT during a particular year will be taxable, in whole or in part, upon receipt by the beneficiaries .

For example, if a \$500,000 CRT, paying out 8% per year (\$40,000.00) had \$5,000.00 of dividend income, \$10,000.00 of capital gains, and \$5,000.00 of tax-exempt income, the beneficiary would be taxed as follows:

\$ 5,000.00	would be reported as ordinary income.
10,000.00	would be reported as capital gain (long term or short term).
5,000.00	would be reported as tax exempt income.
<u>20,000.00</u>	would be received as tax-free return of principal.
\$ 40,000.00	