

CHARITABLE REMAINDER TRUSTS

Prepared by

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Most donations to charity start with a desire to be generous to a cause that you favor. A Charitable Remainder Trust permits you to be generous to charity and generous to yourself! A Charitable Remainder Trust (CRT) is a special kind of trust that is specifically authorized by tax laws to achieve certain goals:

- *Committing to making a future gift to charity (and receiving a current income tax deduction based on the projected gift value), while*
- *Retaining a stream of payments from the gifted property.*

1. When is the use of a CRT indicated?

CRTs are very useful if you own a low-basis, high capital gain asset, (for instance, stock that has experienced significant gains and may be a large part of your investment portfolio or a vacation home that has greatly appreciated), that you would like to sell in order to re-invest in income producing property or to diversify your portfolio. You can always give the property outright to charity, but many people prefer to retain an income stream from this valuable property for retirement, for making gifts or for simple enjoyment. (If you have a lump sum amount of \$300,000 or more that you are thinking of giving outright to charity, please ask for our memo on private foundations).

2. Why is a CRT used with highly appreciated assets?

You do not have to immediately pay the capital gain tax upon the sale of the appreciated property. Instead, you transfer the property to the CRT, the CRT sells the property and does not pay the capital gain tax! This is because CRTs are exempt from income taxes. This sale through a CRT leaves the entire amount of the sales price available for investment within the CRT, instead of being depleted by the gains tax.

3. What type of property can I put into a CRT?

Stocks are often used to fund a CRT. Real estate is another frequent type of property used to fund a CRT. Even small business interests can be placed into a CRT before the business is sold. One type of property that is not suitable for a CRT is mortgaged real estate. Also, it is preferable if you have owned the appreciated property for more than one year.

One note, there are certain rules that apply to CRTs in order to permit you to take an income tax deduction. One rule is that the sale of the property cannot be legally binding *before* the property is placed into the CRT. For this reason, if you are thinking of using a CRT to postpone the payment of gains tax upon the sale of your real estate or business, contact us sooner, rather than later.

4. What are the major reasons for creating a CRT?

A CRT is a fantastic income tax savings vehicle.

First, it lets you sell highly appreciated property without having to immediately pay the capital gains tax. This leaves more money available for you to reinvest and provide you with an income stream.

Second, the gift to the CRT generates an immediate income tax deduction based on the charity's future interest. You can take this deduction against your current income, generally up to 30% of your income. If the deduction is too big to use in one year, you can use it over the next 5 years.

Finally, when the CRT property passes to charity, your estate receives a total charitable estate tax deduction for the amount of the property passing to charity. This reduces your estate taxes.

A word of advice: if the CRT is set to end at your death and if you live to your anticipated life expectancy, the payments to you from the CRT that stay in your estate (if you have not otherwise spent or gifted the payments), will more than offset the removal of the CRT assets from your estate. This is why the payments from the CRT are often used for a gift program, which could include the purchase of an income-tax free and estate-tax free life insurance policy that passes to your beneficiaries at your death.

5. Who can create the CRT?

The person who contributes the property is the Donor. This can be a single person or a husband and wife. Unrelated people cannot jointly contribute to a CRT.

6. What do I receive from the CRT?

When you create a CRT, you elect to be paid either

A flat amount each year (an annuity amount, this would be abbreviated as a CRAT standing for a Charitable Remainder Annuity Trust), or

An amount that fluctuates each year depending on the value of the assets held in the CRT (a unitrust amount, this would be abbreviated as a CRUT, a charitable remainder unitrust).

In either case, the minimum amount that you can elect is 5% per year and the maximum amount is 50% per year.

If you want the peace of mind that you will receive a stated amount, no matter how the CRT assets fare with market conditions, you would opt for an annuity type of CRT.

If you want to participate in the income-tax free growth of the CRT assets and do not mind if your payment slips if the CRT assets decrease in value, you should select the fluctuating unitrust amount, which is a percent of the value of the CRT, with the assets being revalued annually. This is often the choice of our clients. This type of CRT provides a hedge against inflation, presuming that growth in the CRT assets is comparable to the inflation rate.

There are variations on this theme, including a Net Income Make-Up Unitrust (one that only pays you the net income only, which is expected to accelerate in retirement) and the Flip CRT, (one that is funded with hard to sell assets and only pays you the income when the asset is being held and then flips to a CRUT once the asset is sold.) With these variations, it is possible to prepare a CRT that closely matches your concerns and situation. These types of CRTs may be useful if you don't want/need immediate income and you would like the CRT to serve as a retirement vehicle.

7. What if the CRT does not make enough income to pay me?

Generally, if the income of the CRT is less than the amount payable to you for that year, then the principal of the CRT must be distributed to make up the difference.

8. How often do I receive payments from the CRT?

The payment may be made monthly, quarterly, semi-annually or annually, and the choice will affect your income tax deduction (one annual payment slightly increases your income tax deduction).

If you don't need quarterly payments, you should consider one payment at the end of the year; this leaves more money growing within the tax-exempt CRT for a longer period of time.

9. Why do I get a current income tax deduction?

Presuming your CRT qualifies as a split-interest trust (a trust that divides its interest between you and your charities) under all IRS regulations, the IRS calculates the amount that the charity is expected to receive at the end of the CRT's term. This future gift to charity results in a current income tax deduction to you.

10. What is my income tax deduction based on?

Several factors, including: the term of the trust (which considers your age if the CRT lasts for your life), the value of the gifted property, the Applicable Federal Rate (which is the rate or growth that the government determines and this rate changes monthly), and the amount of money you elect to pull from the CRT each year. We have software that we can use to generate different scenarios, so you can decide what is best for you.

Generally, if a CRT lasts for the duration of your life, the older you are the higher the income tax deduction. Also, the less you elect to pull out of the CRT annually, the higher your income tax deduction.

11. What kind of appraisal do I need to satisfy the IRS for my income tax deduction?

Publicly traded stocks use the fair market value on the date of the contribution (the average of the high and low values on that date). A professional appraisal should be obtained before real estate is given to a CRT. You can also use an independent trustee to value real estate, but this may raise IRS eyebrows (something to always avoid). An appraisal would also have to be made for a gift of closely held stock.

12. I would like to make a gift to my children too, should I name them as beneficiaries of the CRT?

CRTs are *not* generally used to make gifts to your children or other individuals. This is because you would be making a gift to that person and

using part or all of your lifetime credit against gift/estate taxes for the gift to a person when, eventually, the person must give up the gift to charity.

If you're worried that you may die prematurely and the CRT will have to be distributed to charity sooner than you would have liked (before you have the opportunity to receive your anticipated payments from the CRT), either select a term of years for the CRT or replace the wealth that is potentially passing to charity with a life insurance policy. You may earmark some of the income stream that comes from the CRT for annual gifts to an irrevocable trust. The trustee of the irrevocable gift trust buys a life insurance policy on you or you and your spouse. The death benefit from the policy goes to your heirs through the irrevocable trust, normally free of both income tax and estate tax.

If you are interested in giving some money to charity now and eventually having the gift pass back to your children, and you are not looking for a current income tax deduction, you may want to create a charitable lead trust (the converse of a charitable remainder trust), and that is a different memo.

13. When does the CRT end?

You can select either a term of years (up to 20) or the lifetimes of you and/or you and your spouse.

14. What happens when the CRT ends?

Upon the deaths of the CRT recipients, (either a single person or a husband and wife), whatever is left will be distributed to the charities you have selected. If you are interested in setting up a Family Foundation, the funds can be distributed to the Foundation. However, this must be stated in the CRT. The limits for your charitable deduction against income taxes for a gift to a private Foundation are slightly lower than the limits for your charitable deduction for a gift to a public charity (usually a 10% difference).

15. What if I die right after I set up a CRT, before I get any payments from it?

There is an easy way to deal with this potential downside—replace the wealth that is passing to charity from the CRT with an insurance policy on your life. The policy should be held in such a manner so that it is paid to your beneficiaries income tax free *and* estate tax free, generally by using an irrevocable life insurance trust as the owner. Alternatively you can elect a term of years for the CRT. If you die 2 years into a 20 year term, your designated individuals will continue receiving the unitrust amount for the next 18 years.

16. What if I change my mind about the charities?

We draft our CRTs to specifically give you the right to change the charities by a writing delivered to the Trustee. You can also give someone else this right (your children, spouse). This is where our CRTs are much more flexible than the arrangements offered directly by a charity. They generally require you to "lock in" a certain gift to that charity.

17. Can I make future contributions to the CRT?

You can, if you have elected the CRUT with the fluctuating payments to you. This right must be expressly stated in the CRT. Each time you make a contribution, you are entitled to another income tax deduction.

18. Can I withdraw all of the funds if I change my mind?

No, the CRT is irrevocable. Therefore, we make it as flexible as we can. Remember, you have already received an income tax deduction based on your gift to the CRT. If you could pull the gift out, the IRS would have to negate your income tax deduction. Only the Trustee is given the ability to amend the CRT and only for the purpose of keeping the CRT in compliance with all tax regulations.

19. Who is the trustee?

While you or another individual can be the Trustee, we strongly recommend that the CRT operations be handled by a professional trust company. The "Trustee" is the person or corporation who shall carry out the terms of your Agreement. A Trustee has a special responsibility to you and your charities to make sure that the terms of the trust are fulfilled. The Trustee is also responsible for making sure that the CRT complies with all tax regulations to preserve its tax-exempt status. We always give you the right to change the trustee.

20. What does the trustee do?

The Trustee makes sure that the payments are made to the recipients on a timely basis. Failure to do this could jeopardize the tax-exempt status of the CRT and your income tax deduction. For a CRUT, the Trustee values the assets each year to determine the amount to be paid out. The Trustee prepares quarterly statements and accountings, handles the distributions to the charities at the end of the CRT, keeps a running tally of the type of income earned by the CRT so the Trustee can tell you how to report your distribution and files Form 5227 (Split Interest Trust Information Form) with the IRS. The Trustee also assumes fiduciary obligations for the management of the CRT assets.

21. What compensation does the trustee receive?

The Trustee is entitled to be compensated for his services. You should review a schedule of the Trustee fees. Some bank trustees charge a 1% fee on top of their normal fee when they distribute property from a trust, other bank trustees do not. You should be familiar with the fees before you retain a trustee. While you can always remove the trustee, you do not want to be surprised by any extraordinary charges.

22. Can I change the trustee?

Yes, if this right is contained within the terms of the CRT. Our CRTs generally permit the payment recipients (be it you or your spouse) the right to change the Trustee. Often, a CRT prepared by a charity's counsel does not give you this right.

23. How is the payment to me taxed?

You will report the payment you receive from the CRT as either (1) ordinary income; (2) long term capital gain; (3) tax exempt income or (4) non-taxable return of principal. The classification is based on the overall type of income earned within the CRT. To the extent that the CRT has earned ordinary income, first that comes out until it is used up, even if this means carrying it forward to the next year. After all the ordinary income is accounted for, then the distribution uses up all the capital gain experienced within the CRT, and so on.

24. What does this "tax tier" system mean to me?

It means that you want to pick the overall least tax rate for you and try to have that type of income within the CRT. Generally, if the long term capital gain rate of 20% is less than your income tax rate, then you and the Trustee would discuss having virtually all of the assets in the CRT only earning capital gains.

25. Can you give me an example of the CRT?

Of course. These examples were created using an 8% AFR, the rate in February, 2000. As the AFR varies each month, the income tax deduction will change. The higher the AFR, the higher the income tax deduction. We will pick the best AFR to give you the highest income tax deduction (either the month of the gift or either of the two preceding months).

These illustrations just give you an idea of how the CRT works. Remember the CRT will grow income tax free, so, like an IRA, you should expect faster growth.

First example: Husband and Wife

Husband is age 70 and Wife is Age 68
They own \$350,000 of GE stock, with a basis of \$50,000.
They give this stock to a CRUT to last for their lives
They elect to receive 8% a year from the CRUT.

Income Tax Deduction: \$91,800

Capital Gains Tax Savings: \$60,000

First Payment: about \$26,000, payments increase annually as CRUT assets increase in value

Second example: Woman age 60.

Vacation beach home worth \$400,000, purchased for \$100,000.
Women places beach home in "flip" CRUT and once it is sold, she elects to receive 10% from the CRUT for 15 years.
After 15 years, she will be past 70 ½ and plans to use her required minimum distributions from a large IRA to support herself.

Income tax deduction: \$93,145

Capital Gains Tax Savings: \$60,000

First Payment: \$36,426 (if the CRUT grows at 10% and if she withdraws that 10% annually, for each of 15 years she will withdraw \$36,426)

26. Can you give me a flowchart of the CRT?

