CHARITABLE REMAINDER TRUSTS BENEFIT EVERYONE EXCEPT THE IRS

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A charitable remainder trust ("CRT") is a trust from which you receive income from the assets held by the trust and a charity receives what remains afterward. Utilizing a CRT can help achieve many different goals, including delaying capital gains tax, converting low yield properties into high yield properties, providing current income tax deductions, benefiting your favorite charities and obtaining an estate tax charitable deduction. Let's look at an example.

John and Jane Smith (a married couple both age 65) own stock in the Murphy Corporation. Their basis in the stock is $20,000. A sale of the corporation to Mega Corporation is being considered and the value of the stock is now $1,020,000. John and Jane want to sell the stock but are concerned with the approximately $150,000 of capital gains tax which will be due and owing at the time of the sale. John and Jane are charitably inclined. How can they sell the stock, diversify their investments, delay the capital gains tax, keep income for life and make gifts to charity? Establishing a charitable remainder trust may solve all of these issues.

If John and Jane transfer the Murphy Stock to a CRT and retain a 5% unitrust interest (a form of income stream) for their joint lives, a charitable income tax deduction of about $350,000 (equal to the current value of the charity's remainder interest in the CRT) will be available to them (which at a 35% federal income tax rate would save them approximately $122,500 in income tax). They would receive 5% of the fair market value of the CRT in income each year, or $51,000 in the first year. In addition, since the CRT is tax exempt, the $150,000 capital gains tax John and Jane would otherwise pay on a sale of the stock individually would be delayed if the CRT is the seller. This deferral is often a significant part of the planning behind a CRT. If the above CRT earned 7% per year, charity could expect to receive over $1,700,000 upon the death of the survivor of Mr. and Mrs. Smith.

There are many technical requirements which must be followed in establishing a CRT. For instance, the CRT must be irrevocable and must provide a form of income stream which satisfies the rules imposed by the tax code. Amounts paid to the income beneficiary of the CRT are required to retain the income tax character the income had when earned by the CRT. The maximum payout to the creators of the annuity is limited under IRS rules, to assure a probable minimum final payout to charity.

A CRT may be set up to provide income to someone other than the creator or a spouse. In that case, a gift tax or estate tax may be incurred. The remainder beneficiary must be one or more qualifying charitable organizations under the tax code, including, with some limitations, a private foundation. The grantor may retain the power to change the charitable beneficiary named in the CRT in favor of another charitable beneficiary or beneficiaries. Often grantors of a CRT will buy life insurance owned by a special life insurance trust payable to children or other family members, to replace the assets passing to charity via the CRT.

The grantor is entitled to an income tax charitable deduction in the year of the contribution to the CRT equal to the present value of the charity's remainder interest. If the deduction is too large to be used fully in the year of contribution, the excess may be carried forward for up to 5 years.

The grantor of the trust may serve as a co-trustee or sole trustee of the CRT. However, if the CRT owns closely held stock, real estate or other assets which do not have an objective and ascertainable market value, an independent trustee must be the sole party responsible for making the annual determination of value.

When the grantor dies, the then value of the CRT's assets will be includible in the grantor's estate if the grantor retained a right for life to receive the trust's income stream. However, the value of that remainder interest should qualify for an estate tax charitable deduction because the CRT will transfer all its assets to charitable organizations qualified for deduction under the tax code.

When people consider setting up a CRT and contributing property to the CRT to sell, the CRT must be established before the legal obligation to sell is binding. If the CRT is legally bound or can be compelled to sell the assets at the time of contribution, the donor may be subject directly to the capital gains tax on the sale.

Obviously, the CRT is a sophisticated estate and charitable giving technique. A CRT should not be used without competent advice and careful drafting by a tax attorney.

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