

Time To Revisit Charitable Remainder Trusts?

With clients worried about a perceived stock market top in the near term and a potential recession in the next 18 months, it's probably a good time to look at an old favorite in our Estate and Trust planning toolbox: the **Charitable Remainder Trust** (generally referred to as a "CRT"). A CRT is a useful type of irrevocable trust that allows its maker(s) to retain (or give to others) certain fixed benefits from the trust for one or more lifetimes or a period of years before ultimately distributing the remainder of the trust to a favorite charity. Once established in accordance with statutory requirements, the IRS will treat the trust itself as a type of charity.

The Benefits of Implementing a CRT in Your Planning

While this strategy can be used appropriately for [estate planning](#) purposes, there is one tax reason that stands head and shoulders above all of the many CRT benefits: the ability to avoid immediate capital gains tax on the sale of appreciated assets. Using a CRT, a client can lock in appreciated gains, diversify out of concentrated positions, and/or go to cash, without immediate tax implications.

The CRT strategy offers a number of other significant planning advantages. A person who uses this strategy can also expect to:

- **Receive an immediate [federal income tax deduction](#)** for his or her gifts to the trust that will put an additional charitable deduction directly into his or her pockets as a bottom line income tax savings;
- **Create an income stream for life or a period of years** that is greater than if the asset was held or sold;
- **Diversify their investment portfolios** without having to pay a tax penalty to do so;
- **Shelter large amounts of principal** from the claims of potential [unforeseen creditors](#);
- **Avoid potential federal and Maryland [estate tax](#)** on the value of the assets that will pass to charity; and
- **Benefit preferred [charitable organizations](#)** in lieu of the federal and state governments.

The mixture of which benefits are most important to a particular person varies depending on circumstances and goals, but there is one given for virtually all people who are interested in

CRT planning: The desire to sell appreciated assets free of tax and retain substantial benefits from those assets.

A Brief Description of the Strategy

When a person owns appreciated property that they would like to sell, they are faced with the conundrum of having to pay capital gains taxes on their profit, much of which may be attributable to pure inflation rather than a real increase in value. If they instead transfer their appreciated property to a CRT that is created just for them, those assets can be sold without the immediate payment of any federal or state capital gains tax. Structured correctly, giving property to a CRT can result in a **greater** rate of return for an individual and a **greater** amount of assets passing to family members than if the same assets were sold during the owner's lifetime and then were passed to family members at death.

While a CRT is a complex planning strategy, its basics are relatively simple. Here, in essence, is how a CRT works:

1. The person who wants to make a gift, called the *trustmaker*, transfers appreciated property to the *trustee* of the CRT.
2. The *trustee* can be the trustmaker(s) or other individual(s), or it can be a bank trust department or trust company. The trustee administers the trust, invests the trust assets and sells the appreciated assets. Because the trust is treated like a charity with regard to the recognition of income, the proceeds are free from **all** immediate income tax.
3. When the trustmaker gives property to the CRT, the *income beneficiary or beneficiaries* receive income from the trust for life or for a period of up to 20 years. This amount is chosen by the trustmaker, but cannot be less than a 5 percent return on the value initially transferred. The trustmaker(s) are usually the income beneficiaries, but in some cases others are additional income beneficiaries.
4. CRT distributions are income taxable to the income beneficiaries when received from the trustee under the "four tier" structure discussed below. As such, except for the share of trust income and capital gains that ultimately passes to a charity or charities (that pay no income tax), income tax on CRT income and recognized capital gains is deferred, not escaped. However, such deferral is a powerful tool when income recognition is postponed until years when the rate of taxation is lower or when additional deductions may be available. For example, with proper planning, income

might be deferred until later years when overall taxable income is lower or when, such as after 2025, we revert to the allowable tax deductions that were available before the [2018 Tax Cuts and Jobs Act](#).

5. The trustmaker gets a current income tax deduction in the year the trust is established for the value that is ultimately predicted to go to charity. Note that because the CRT makers are only giving away the principal that is left after a predicted or prescribed period of years, this deduction is not for the full value of the assets that are placed into the CRT. The amount that ultimately should go to charity is calculated using annuity and life expectancy tables and an interest rate prescribed monthly by the Internal Revenue Service. The income tax deduction will vary depending on the ages of the income beneficiaries (or the period of years that the income benefit will be paid to him, her, or them), the amount of projected income that the income beneficiaries will receive on a regular periodic basis, and the value of the initial gift made to the CRT. At the time the CRT is created, the present value of what is predicted to pass to charities at the end must be at least 10 percent of the value of the contributed assets. This deduction is fixed at the outset, regardless of the actual performance of the CRT and what actually passes to charity in the future.
6. Upon the death of the income beneficiary or beneficiaries (or the passage of a prescribed period of years), whatever is left in the CRT passes to one or more public charities. These charities must meet certain tests to be qualified charities, but these are generally the same tests that must be met to make a charitable contribution income tax deductible.
7. Any amounts that pass, or are predicted to pass, to qualified charities after the death of the trustmaker are not taxed in the estate of the trustmaker for federal and state estate tax purposes because of the estate tax charitable deduction.

Types of Charitable Remainder Trusts

There are generally three kinds of CRTs:

- Charitable Remainder **Annuity** Trusts ("CRATs"),
- Charitable Remainder **Unitrusts** ("CRUTs" or "S[tandard]CRUTs"), and
- Charitable Remainder **Unitrusts with Net Income Make-up** provisions ("NIMCRUTs")

It is also possible to combine the advantages of the NIMCRUT and the standard CRUT by having the NIMCRUT convert into a standard CRUT after the occurrence of a specified event

(e.g., a birthday or a date or the sale of property for which the market is uncertain) that is theoretically outside the control of the trustmaker.

The Charitable Remainder Annuity Trust

A CRAT guarantees the income beneficiary a fixed percentage of the original amount that was given to the trust. For example, if the terms of the CRAT state that the income beneficiary is to receive a 10 percent return on the \$5 million the trustmaker originally placed in the CRAT, then the income beneficiary would receive \$500,000 each year from the CRAT regardless of whether that principal grows to \$10 million or drops to \$3 million. Investment performance does not affect the amount of the annuity payment.

The CRAT technique is usually embraced by older people who are betting that we are more likely to have economic deflation than inflation, that want to lock in historically high rates of inflation, or who simply do not want to take the chance that they will receive less than the amount originally chosen.

Because of the fixed nature of the annuity required in a CRAT, additional contributions cannot be made to these trusts. The original gift cannot be enhanced.

The Charitable Remainder Unitrust

A CRUT is distinguished by the feature that it guarantees the income beneficiary an income equal to a percentage of the changing value of the trust assets. If the terms of the CRUT state that the income beneficiary is to receive a 10 percent return on the value of the CRUT's assets and the trustmaker made an initial gift of \$500,000, then the income beneficiary would receive more than \$50,000 each year if the trust increases in value, and less than \$50,000 each year if the trust decreases in value. Investment performance determines the amount of the income interest that the income beneficiary receives.

The CRUT technique is most effective for people who believe that inflation and/or appreciation will continue, allowing their CRUT payments to rise with that inflation and/or appreciation.

Because of the flexibility of CRUTs, many makers contribute additional cash or property to them throughout the years.

The Charitable Remainder Unitrust With Net Income Make-Up Provisions

A NIMCRUT can be distinguished from a regular Charitable Remainder Unitrust in that there is trust language that allows the income beneficiaries to forgo taking income in those years when it is not needed and to defer that income to later years when it will be needed. The income that is not taken currently is not taxable until it is taken out of the trust in future years, allowing effective income tax deferral.

Especially when it is combined with a standard CRUT after a designated "flip" event, a NIMCRUT offers immense planning opportunities. It allows individuals who have a high current income to shelter their capital gains while deferring income to years where their income may not be as high. In addition, the trustmaker can give additional contributions of cash or property whose growth will also be sheltered on a tax deferred basis. A NIMCRUT also can be a substitute for a qualified retirement plan.

Taxation of CRT Income Distributions

Income received from a CRT by recipients who are not charities is taxed for income tax purposes under a "four tier" structure that is based on the historical nature of the trust's operations. First, distributions are taxed to recipients as ordinary income to the extent that the trust has at any time previously earned such ordinary income (e.g., dividends and interest) that has not previously been taxed. To the extent that all prior ordinary income has thus been distributed, distributions are next taxed as capital gains to the extent that the trust has at any time realized such profits and has not previously distributed them. When all prior capital gains have been distributed, distributions are reflected as tax-free income (e.g., municipal bond interest) if and to the extent that the trust has received such tax-free income. Finally, when all of these income categories have been distributed, distributions are treated as a distribution of nontaxable trust principal.

As the result of IRS requirements for the income taxation of CRT distributions, CRT trust accounting can be rather complicated. The use of a knowledgeable CPA or professional CRT administration firm is often a good idea. Fortunately, the expense required to pay for such accounting is incurred by the trust itself and not directly by the trustmakers or income beneficiaries.

Likely Candidates for CRT Planning

While CRT planning usually best coincides with clients who ultimately want to make some ultimate contribution to charity, this is not always the case. Income tax deferral can make these trusts useful, regardless of charitable intent. In fact, such deferral is so useful that the IRS limits the types of investment that are eligible for CRT use. For example, the contribution of hard-to-value assets (like real estate, closely-held stock, and tangible personal property) will require the CRT to have an independent Trustee. And CRTs are generally not designed to accommodate gifts of assets encumbered with debts, business inventory, limited partnership and LLC interests, real estate investment trusts, listed options, and installment obligations. Contributions of these types of assets could invalidate the trust or create significant income tax problems and should be avoided in almost every situation. On the other hand, appreciated marketable stocks and bonds are wonderful candidates for contribution to a CRT. That's what makes the CRT worth considering if the stock market is nearing its top or a recession is impending.

If you find yourself worrying about how to liquidate appreciated and/or concentrated security investments or a need to diversify your investments without immediate capital gains taxation, please feel free to call me at (410) 224-7800 to discuss if a CRT could be a solution to your problem.