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CHARITABLE REMAINDER TRUSTS

Guy S. Emerich
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There are many techniques available to clients concerned about taking care of their family's financial needs and also reducing estate taxes after their passing. This newsletter will explore one such technique involving the use of Charitable Remainder Trusts (CRTs).

A CRT is a trust usually created during one's lifetime, although it can come into existence only upon one's demise. It is an irrevocable trust aimed at benefiting not only the maker of the trust (called the settlor), but also the settlor's family and ultimately a charity of the settlor's choice. CRTs come in two forms. One is known as a Charitable Remainder Unitrust (CRUT), while the other is a Charitable Remainder Annuity Trust (CRAT).

The CRUT pays a percentage of the value of what one contributes initially to the trust. In subsequent years it pays that same percentage but on the recalculated value of the trust principal. If for example, a client puts in \$500,000 and reserves a 7% interest, then in year one the client will receive \$35,000 of income. If in year two the trust principal is worth \$600,000 then the client will receive \$42,000 in that year. By the same token, if the trust principal is worth \$450,000 in year two then the client will receive 7% of that amount or \$31,500. A CRUT should be thought of therefore as similar to a variable annuity.

On the other hand, a CRAT pays the client the same fixed amount for the balance of the trust term. If under the same facts the client contributes \$500,000 and reserves 7% then the client will receive \$35,000 for the rest of the trust term regardless of the change each year in the value of the principal. Even if the principal turns out to be \$600,000 in year two the client will still receive \$35,000. It is therefore to be thought of as similar to a fixed annuity.

CRTs are frequently used for clients who have holdings of a large amount of a single stock which they have not wanted to sell as they did not want to incur the capital gains tax. If the stock is contributed to a CRT then neither the settlor nor the trust pays any capital gains tax as the sale was by the charitable trust and not the individual. If one further assumes that this stock was only paying a dividend of 1% per year, the settlor can now find himself with a much higher return on his investment.

CRTs also have value in planning to help future generations. Assume for a moment that Mr. and Mrs. Canon are ages 74 and 72. Further assume they have a daughter, Bonnie, who is 45 years old and just went through a divorce. The Canons are concerned about Bonnie's financial



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future. They have a large holding of stock worth \$500,000 but with a basis of \$100,000. The stock pays an annual dividend of 1%. The Canons decide to create a CRUT which will pay them 7% for the rest of their lives. In addition they will set this up so that their daughter, Bonnie, will also receive 7% for the rest of her life.

Here are the numbers. First, in year one Mr. Canon will receive \$35,000. Let's assume in year two the trust is worth \$550,000. In that year he will receive \$38,500. At his death Mrs. Canon will now receive that 7% for her life. At Mrs. Canon's death Bonnie will receive the 7% for the rest of her life. When Bonnie dies the remaining trust assets will go to the charity that the Canons had selected.

There are income tax advantages for the Canons at the time they create this CRUT. They will receive an income tax deduction of a little over \$59,000, which if not used in the year the trust is created can be carried forward. The \$59,000 is the present value of the remainder interest that will go to the charity when the trust ends. The assets passing to charity will not be taxed in the Canons' estate for estate tax purposes as they are going to charity. Note, however, the value of the income stream that will pass to Bonnie will be considered an estate asset. Finally, the money the Canons and Bonnie receive will be subject to income tax but how it is treated, e.g. ordinary income, capital gain or non-taxable income, depends on the nature of the income generated by the trust.

In summary, this technique helped the Canons reduce their estate tax bill, obtain an income tax deduction, avoid the capital gains tax on the gain in the stock, provide a lifetime stream of income to their daughter and finally also benefit charity. Consider consulting your attorney or tax professional to see if a CRT is right for your estate plan.

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