

Charitable Giving Revisited

Advanced strategies using a charitable remainder trust.

BY MICHAEL P. HATCH, CFP, JD



My column in the April issue of *Endovascular Today* reviewed the basics of charitable giving and why it pays to plan your gifts rather than simply writing checks from your checking account. This article reviews the highlights of several other strategies often used by clients who wish to accomplish several goals in concert with their charitable giving strategies.

CHARITABLE GIFTS OF PARTIAL INTERESTS

There can be significant benefits for donors who make charitable gifts of less than their entire interest in property, which is known as a *gift of a partial interest*. Why is it called a *partial interest*? A gift of your full interest in property is exemplified when you write a check to your favorite charity; the gift is completed once you write the check and hand over the funds to the charity. Thus, you are giving your full interest in the property. You no longer control any aspect of that gift, other than maybe a restriction on the type of charitable activity for which you direct the charity to use your donation. The value of the gift is clear because you have fully given the gift, and we can assess the value of the cash or other asset that you have donated.

When a partial interest gift is made, you are giving less than the full value of the property, and so the value of the charity's interest must be determined. The donor receives something in return for the gift, whether it is an income stream, or some other economic benefit. These gifts often take the form of a charitable remainder annuity trust or unitrust, a charitable gift annuity, a pooled income fund, a charitable lead trust, or a gift of a remainder interest in a farm or personal residence. These gifts each have different benefits, are intended for different circumstances, and require careful consideration as to your income tax, estate and gift tax, as well as your overall estate plan. Although all of these tools are useful, we will concentrate on the charitable remainder trust (CRT) because it is among the most versatile of arrangements.

WHAT IS A CRT?

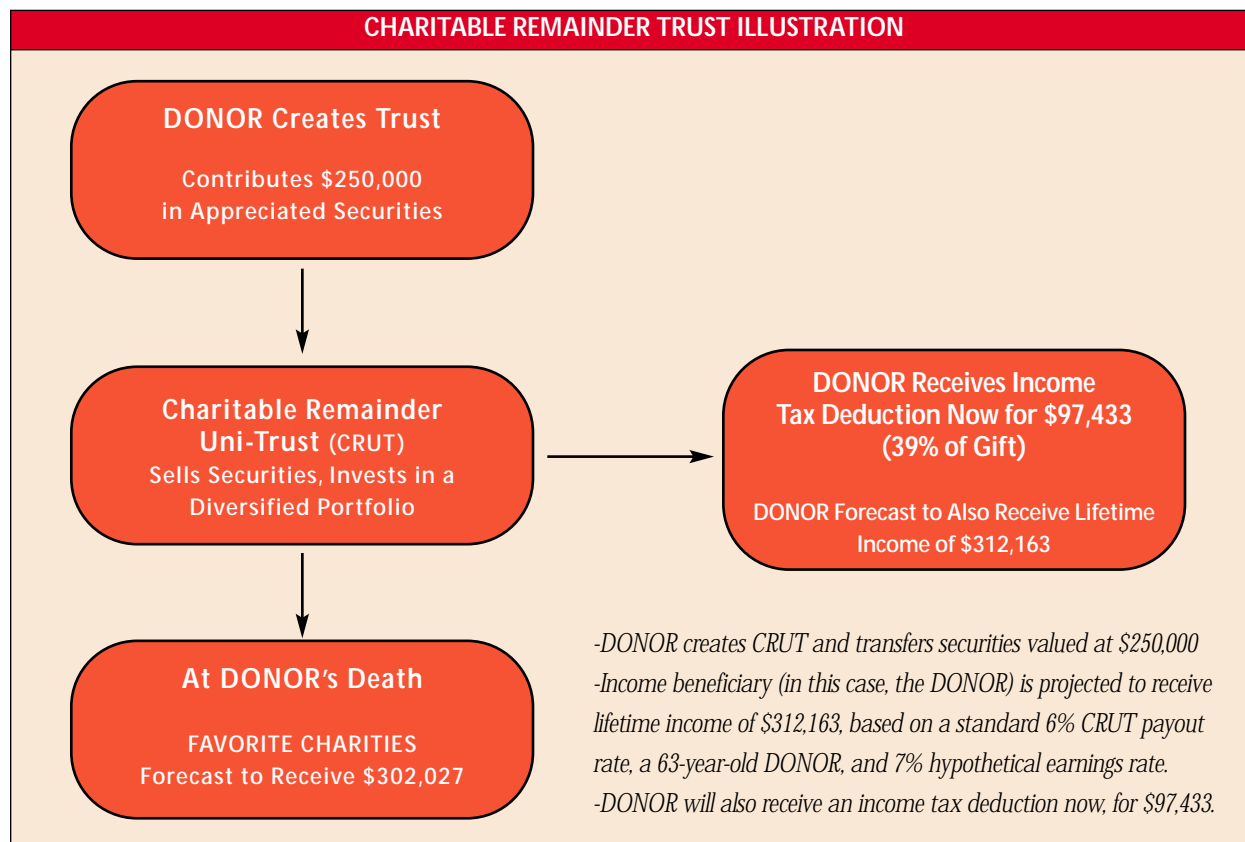
With few exceptions, gifts to charity of partial interests in property do not qualify for the income tax charitable deduction. One of the most important exceptions to this partial interest rule is for gifts made to charity through CRTs that meet statutory requirements. CRTs may provide benefits for both individuals and charities without violating the partial interest rule.

A CRT is a unique kind of irrevocable trust in which the donor makes a gift to a special trust, receives income from the trust for life or joint lives (or for a specified period of up to 20 years), after which the trust terminates and the trust principal is distributed to the charitable beneficiaries.

The income payout period may last for more than one life, but the present value of the charitable remainder must be 10% or more of the initial value of the property transferred to the trust. As the income payout period stretches out (due to young or multiple beneficiaries), the value of the charity's remainder interest decreases due to time-value-of-money principles, potentially jeopardizing the tax-qualification of the trust. Because a CRT can be arranged to pay income to the donor (or other individual) for as long as he or she lives, it often permits the donors to make a major gift to a charitable institution, and gain immediate income tax benefits, without a loss of spendable income during their lifetime. It is especially appropriate for the donor who can afford to give away assets but who wants to increase the income produced by those assets. While the trust itself is irrevocable, the donor can maintain certain controls, including choice of trustees, and thus some investment control and the ability to change charitable beneficiaries.

INCOME, GIFT TAX AND ESTATE TAX CONSIDERATIONS

In addition to receiving an annual income payment from the CRT (more frequent payments, such as monthly or quarterly, are allowed), the donor does not pay federal or state income or capital gains tax on the sale of most appre-



ciated assets if those assets are sold after they are transferred to the CRT. The donor is also entitled to an immediate income tax charitable deduction for the present value of the charity's remainder interest, generally in the year that the CRT is established. This deduction is calculated pursuant to a formula using the percentage payout stated in the trust, the type of asset donated, the life expectancy of the income beneficiaries, as well as other potential factors. Remember, it is only a partial deduction—a donor making a gift of \$100,000 in stock might only receive a total income tax deduction for 40% of that gift because the donor is reserving the right to receive the income from those funds for his or her lifetime. The deduction may be claimed in the year of the gift and, if any portion exceeds the percentage limitation in that year, may be carried over and deducted for up to 5 subsequent years. There is also a deduction limit of your adjusted gross income each year, depending on the type of asset and nature of the charity to which you are donating.

The income paid out from the CRT each year is subject to income taxes and has its own specialized accounting treatment. This so-called four-tier accounting system for taxing CRT distributions presumes that the most heavily taxed income is the first to be distributed from the trust. Thus, all ordinary income and short-term capital gain income is

taxed first, before an income beneficiary would receive long-term capital gain income or potentially even tax-free income or return of principal. Although the income beneficiary receives taxable income, remember that transactions within the CRT are generally income tax-exempt. This allows a donor to sell a highly appreciated asset and receive the income derived from the full value of the asset, not diminished by the payment of federal and state capital gains taxes, which could claim 15% to 25% of an asset's gain.

Besides income tax benefits, a CRT can reduce federal gift and estate taxes by transferring assets out of the donor's estate. If the donor and/or the donor's spouse are the only income beneficiaries, the assets donated to the trust escape federal gift and estate tax due to the unlimited charitable and marital deductions.

CRTs come in two main forms, the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT).

CRATs

A donor establishes a CRAT by irrevocably transferring cash or appreciated property to a properly created trust. The trustee is required by the trust instrument to pay a specified annual annuity amount to the donor or other designated individual beneficiaries for a certain period of time

(often the lives of the beneficiaries), with the trust property passing to a designated charitable institution at the end of this time period (keep in mind, this charitable institution could be your private foundation or donor-advised fund, managed by your hand-picked successors). This income percentage must be at least 5% of the initial value of the assets transferred to the trust, but not more than 50%. The value of the charitable remainder must be at least 10% of the net fair market value of all property transferred to the trust, as determined at the time of the transfer. The income beneficiary of a CRAT must receive the same required annuity payout each year, even if the trust does not produce any income, and only a one-time initial contribution is allowed. Principal may have to be invaded, if necessary, to make the required payout.

CRUTs

A donor also establishes a CRUT by irrevocably transferring cash or appreciated property to a trust. However, in a CRUT, the income beneficiaries receive a specified percentage of the value of the trust assets as revalued each year. If the trust principal increases in value, the income payout also will increase; likewise, if the trust value decreases, the income payouts will decrease (for example, if your CRUT value were \$200,000 at the end of the year. At a 6% CRUT payout, your payout the following year would be \$12,000; if the account value dropped to \$190,000 the following year, the payout would only be \$11,400). The income payout parameters are the same as the CRAT, however, a CRUT allows the ability to make additional contributions, and comes in several varieties, including:

Standard fixed-percentage CRUT

Described previously, and features a payout rate of 5% to 50% of the trust's assets each year, depending on value.

Net-income (without make-up) CRUT (NICRUT)

Can limit payouts to the lesser of standard CRUT percentage, or net income actually earned by the trust.

Net-income with make-up CRUT (NIMCRUT)

If this option is selected, the trust agreement may provide that, if less than the specified percentage is paid out in one or more years, the accumulated income deficits will be made up in subsequent years in which income exceeds the specified percentage.

So-called flip CRUT

The flip unitrust option allows a NICRUT or a NIMCRUT to convert to a straight CRUT upon the occurrence of a permissible triggering event, such as the sale of the liquid asset(s) (eg, sale of a piece of real estate) used to fund the

trust. This is useful when the donor does not want the trust payout restricted by the net income limitation after the asset is sold or some other flip-triggering event occurs, within the guidelines specified by regulations.

The NICRUT and NIMCRUT technique can be used to time trust income payouts to coincide with the donor's need for retirement income. In addition, the definition of what constitutes net income in the trust can vary by state law, but as the saying goes, "the devil is in the details." Within certain parameters, you should be able to define net income in an advantageous manner, so you're able to meet your income needs and manage the trust in the fiduciary manner required.

ADMINISTRATION OF CRTs

Careful administration of a CRT, including following the statutory guidelines, having a systematic approach to the trusteeship of the CRT, proper accounting systems and controls, as well as the filing of appropriate tax documents, are absolute essentials to successfully running a CRT. IRS rules do allow you to be your own trustee in most instances. But, you do not have to fulfill all of these tasks yourself, you can hire or delegate these tasks to the appropriate professional advisors. However, if one handles these tasks with care and takes into account the remainder interest of the charitable beneficiary, these instruments are considered by many to be among the most versatile and effective financial planning tools for diversifying your assets without capital gains and potentially increasing your income from lower-yielding investments (see illustration).

FINANCIAL GOALS AND CHARITABLE GOALS ARE NOT MUTUALLY EXCLUSIVE

Although personal satisfaction of supporting worthwhile causes drives charitable giving, doing so in a tax-effective manner that supports your overall estate and retirement income needs should not be considered mutually exclusive. Each CRT described has its own unique advantages and limitations, and finding the right combination for your situation might help you accomplish several goals at once. ■

Michael P. Hatch, CFP, JD, is a Financial Advisor and Principal with The Sterling Group, a financial planning and fee-based investment firm located in Southern California. Mr. Hatch is a branch manager and offers securities through Linsco/Private Ledger (member NASD/SIPC), the largest independent brokerage firm in the US. Mr. Hatch specializes in working with entrepreneurs and professional practices, assisting them in defining and implementing their financial, philanthropic, and intergenerational planning strategies. He may be reached at (626) 440-5995; michael.hatch@lpl.com.