Charitable Remainder Trusts

What is a Charitable Remainder Trust (CRT)?

In the United States, CRTs were established by the Tax Reform Act of 1969 under Internal Revenue Code Section 664. The Code provides an incentive for charitable giving different from making outright gifts by allowing a current tax deduction for a split interest gift, i.e., one that provides a lifetime income benefit to the donor (or their designated beneficiary) and a future gift to a charity.

What is the motivation for establishing a CRT?

1. If a donor makes an outright gift to a charity, the donor gives up all the interests in the gift and in exchange receives a tax deduction for the amount given. A CRT, however, is designed to provide an incentive for those who cannot, or are not, willing to part fully with their assets. The CRT does this by allowing a current tax deduction for a future gift to a charity through the establishment of an irrevocable trust. The assets gifted to the trust provide a current income stream to the donor (or designated beneficiary) and a future principal value to a charity. The tax deduction is based on the market growth in value, reduced by the expected payments to the income beneficiary.

2. In addition to the current tax deduction, the Code provides that unrealized gains on assets placed in the trust are not taxed, even if sold. Therefore, the donor is able to convert concentrated assets into diversified assets, reducing the risk to his or her income stream (and to the charity's interest as well). This provides an incentive to make charitable gifts of highly appreciated assets subject to capital gains tax.

3. Likewise, the trust itself is not taxed on the income and gains generated by its holdings. The beneficiary is taxed, however, on the income payments received from the trust. The tax on payments means that from a tax policy perspective, all income and gains received from the trust by the donor are taxed appropriately (rules require the payments to be taxed on the character of the income and gains received inside the trust with the highest tax rates applied first), while the assets left in the trust for the charity are not taxed.

How does a CRT work?

1. The donor, often guided by a financial advisor such as a lawyer, accountant, other financial advisor, or a representative of a charity, is made aware of the differences between CRTs and outright fits and decides to establish a CRT.

2. The donor decides who the income beneficiaries (often husband and wife) will be (there must be at least one individual and the trust can be for a lifetime or a specific term of years). Successor beneficiaries are allowed, however, the longer the life expectancy, the lower the tax deduction. The donor also determines what the payout rate will be and whether a fixed dollar amount (annuity trust) or a fixed percentage amount (unitrust) will be used. Fixed payments are usually more appropriate for older beneficiaries who want to avoid risk of income volatility, while younger beneficiaries usually choose a variable payment in hopes it can grow over time. Note that decisions regarding payout rate and term are fixed and cannot be changed. Both decisions significantly affect the pattern of the income flow to the beneficiary and the remainder value available to the charity, as well as the tax deduction (which is reduced for longer lives or higher payments). Due to the long term nature of most CRTs and the complex interaction of investment returns, payments, and taxes, it is important that the expected flows to both income beneficiaries and the charity be modeled and understood before these decisions are made.

3. The donor decides what charity will be the remainder beneficiary. If the charity is to be the trustee, they will usually ask to be name irrevocably as the remainder beneficiary, but otherwise, the charity may be changed during the trust life. The donor is not obliged to inform the charity, but this would be unusual. Usually the trustee has a duty to inform the charity of its designation as a remainder beneficiary of a trust and to provide appropriate reporting so the charity can monitor the trustee's care of their remainder interest.

4. The donor determines who will be the trustee of the trust (in the U.S. often the charity itself or a financial institution) and establishes the trust. The trustee has important duties under the law to property care for the trusts and to property balance the interests of the income beneficiary and the remainder charity, since in some situations the interests may be in conflict. It is important to note that the donor gives up to the trustee the ability to control the trust in exchange for the tax deduction.

5. The donor funds the trust by transferring the gift assets into the trust. Most trusts are funded with appreciated assets (stocks, bonds, real estate, etc.,) that would incur capital gains tax if sold, but trusts are sometimes funds with cash. The trust technically does not come into existence until it is funded and the donor gives up physical control of the assets to the trustee.

6. The donor receives a tax deduction based on IRS tables which estimate the value expected to be received by the charity by taking into account expected trust life, payments to income beneficiaries, expected returns, and the initial market value of the asset. Assets that are not public marketable securities (listed stocks and bonds) require an appraisal process to verify the initial value of the gift.

7. Usually, the trustee sells the gifts asset(s) and diversifies the portfolio. In the U.S., trustees in most states are subject to the Prudent Investor Rule which provides guidelines for appropriately diversifying and investing portfolios in order to protect the income and remainder interests from imprudent risks. Again, neither the sale of the funding trust assets or portfolio income and gains inside the trust are taxed.

8. The income beneficiary typically receives quarterly payments from the trust. Minimum payments are 5% under current law and cannot exceed 50%. In addition, rules require that the charity be expected to receive at least 10% of the initial gift amount. Higher beneficiary payments reduce both the tax deduction and the ability to grow the portfolio and therefore future income. Therefore, there is an incentive for the donor to select reasonable payments. Typical payments are 5% - 6% for beneficiaries 65 or below and 7% - 8% for older donors. Donors with life expectancies of ten years or less are probably better off with a fixed annuity trust, while those with longer expected lives typically choose unitrusts which pay a fixed percentage of market value.

9. Assuming a well constructed portfolio and a reasonable payout rate, the trust should grow over time. For example, a portfolio consisting of 70% stocks and 30% bonds might have an expected average annual return of about 8%. If the payout is 5% and inflation 3%, then the real value of the portfolio (net of inflation) that will go eventually to the charity, and the purchasing power of the income it can produce would stay constant (since the 8% return exactly offsets the 5% payment and the 3% inflation effect). If the payout is higher (say 8%), then the portfolio would stay constant in nominal dollars (8% return less 8% payment), but the real value of the principal would be eroding each year by the rate of inflation. Even small amounts of portfolio value erosion in real terms can have a significant effect on the eventual value to the charity for a trust that may last 20 years or more. Erosion in real value also reduces the purchasing power of the income received by the beneficiary each year. Below average investment returns of a poor investment approach would cause similar outcomes for both income beneficiary of the charity.