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PLANNING WITH CHARITABLE REMAINDER TRUSTS

Most people have never heard of Charitable Remainder Trusts (CRTs), even though they have been officially recognized since the 1960s. However, with recent changes in the tax laws, many clients are recognizing that these trusts are one of the last tax-advantaged investment vehicles.

Recent Tax Law Changes

Tax law changes over the past several years have reduced or eliminated many of the tax advantages associated with owning real estate. In most cases, deductions produced by owning investment real estate can only be used to offset income from the property, not to reduce earned income or income from other investments.

In addition, when individuals die and pass their assets to their children, the estate may be subject to additional tax. In many instances, this death tax will reduce the value of the inheritance by thirty-five percent (35%) or more.

Why Are CRTs Special?

The tax laws have long afforded special benefits to non-profit (charitable) organizations. In most instances, these organizations are exempt from taxation.

A CRT is set up for the ultimate benefit of such tax-exempt organizations. As a result, the trust is allowed many significant tax benefits.

How Do CRTs Work?

These trusts are relatively easy to understand in concept.

First, the client transfers property to the trust. Then the Trustee sells the property and invests the sales proceeds for the client's benefit. The clients, and anyone else they designate (such as a spouse or children), receive the earnings on the investments for their lifetimes. Upon the death of all income recipients, the remaining funds are distributed to charitable organizations selected by the client.

What are the Advantages?

CRTs produce several tax advantages for the client.

Bypass Capital Gains Tax. If debt-free property is transferred to the trust, the client can escape capital gains tax on the transfer. However, if mortgaged property is used, there will be some capital gains tax, although it is usually less than if the property is sold outside the trust.

More importantly, there is no capital gains tax when the Trustee sells the property. This bypass of tax will significantly increase the amount of money available for investment on behalf of the client.

Income Tax Deduction. When the asset is transferred to the trust the client is entitled to an immediate income tax deduction. This deduction can be used to offset the up to thirty percent (30%) of the client's other income. This deduction is available for up to six (6) years including the year the trust is created.

Tax-free Accumulation. Excess earnings can be accumulated in the trust without incurring income tax. In this respect, the trust works much like an IRA account or qualified retirement plan.

The net effect of the tax-free compounding is that the trust will grow more quickly and provide more income to the client.

What About The Kids?

Because the trust assets ultimately go to charity, many clients choose to replace the inheritance to the children by using life insurance owned by a separate Inheritance Trust. The cost of the insurance can be provided by the initial tax savings and a portion of the increased cash flow. Usually the insurance is fully paid in seven (7) to ten (10) years.

Since the insurance is owned by a separate trust, it can go to the kids free of estate taxes. This is particularly attractive for individuals with estates worth more than $5 million.

A second alternative is to have the children as income beneficiaries of the CRT. This will assure that the trust income will continue for their lifetimes. Although this reduces much of the estate tax benefit, it may be a desirable strategy if the client is uninsurable.

Who Can Be The Trustee?

The client has the ability to select whomever they want as Trustee, including himself/herself. In most cases, because of the administrative responsibilities associated with these trusts, it is desirable to have an independent Trustee, such as a bank or trust company, or an advisor who is capable of complying with these administrative responsibilities. The client may retain the right to remove the Trustee in the event they are dissatisfied with the Trustee's performance.

What Assets Can Be Used?

It is possible to create a CRT with a wide variety of assets. Frequently, stocks, bonds or partnership interests are used. Because of the tax advantages of the trust, it is usually best to use assets that have increased substantially in value. Often these are assets that the clients want to sell to increase their income.

What Are The Downsides?

CRTs have a few downsides in relation to other planning strategies.

First, the trust must be irrevocable. Once a trust has been created, it cannot later be changed or cancelled.

Second, although the clients can receive all income, generally the underlying trust assets must remain intact. This means that these assets will not be available for unexpected expenses, such as medical needs.

Third, the Trustee is prohibited from investing the trust assets in a way considered potentially abusive by the IRS. This generally means that the Trustee should pursue a fairly conservative investment strategy and is prohibited from acts of self-dealing.

Who Should Consider A CRT?

CRTs should be evaluated by anyone over fifty (50) years old who is looking to increase their income. They are particularly appropriate for those planning for retirement, especially individuals who have under-performing, appreciated assets.