

# Topics in ESTATE PLANNING

## Charitable Remainder Trusts

*Set Up a Charitable Remainder Trust to Benefit Both You and Others*

**W**HAT WILL ALLOW YOU TO SELL HIGHLY appreciated assets, defer capital gains tax and build a diversified portfolio, while providing you with cash flow and an income tax charitable deduction at the same time? A charitable remainder trust (CRT). Here's a look at how this financial planning tool can help you and your family while benefiting your favorite charity.

### *Choose The CRT That's Right For You*

To set up a CRT, you contribute assets — ideally highly appreciated ones — to a trust that will ultimately transfer them to charity. Once it is funded, the trust pays an annual amount to you and/or one or more other beneficiaries for life or for a fixed number of years not to exceed 20. Beneficiaries can include you, your spouse, children, friends — you can even give a slice of the annual amount to charity. In a charitable remainder unitrust, the annual payout is generally based on a percentage of the current fair market value of the trust's assets. In a charitable remainder annuity trust, a fixed dollar amount is paid for the life of the trust. In a standard “fixed percentage” charitable remainder unitrust, the payout fluctuates with the value of the trust: the more the trust grows, the larger the payout. For some situations, variations on the theme will be the right fit. For example, those who don't need cash flow may decide on a “net income alternative” unitrust, which pays the lesser of net income or the fixed percentage amount. If you want to fund the trust with an asset (e.g. raw land) which currently generates no income, the best choice may be a “flip unitrust,” a hybrid of the net income alternative and straight percentage unitrust.

Although the tax code limits how much the individual beneficiaries can receive over the life of the trust (based on various actuarial and interest rate assumptions), the rules are liberal. For example, in April 2002, a 55-year-old could take back a return of as much as 6% from a charitable remainder annuity trust and as much as 13% from a charitable remainder unitrust. The older the designated individual beneficiaries, the higher the permitted payout. For example, a 70-year-old can take back a return of as much as 7% from a charitable remainder annuity trust in April 2002 and 27.8% from a charitable remainder unitrust. The trust document can specify the frequency at which you want payments made — annually, quarterly, even monthly.

### *CRT Benefits*

A well-designed CRT has well-defined tax and economic benefits.

▶ A properly administered charitable remainder trust does not pay capital gains tax because it is tax-exempt. If you name yourself or your spouse as the beneficiary of the trust, the capital gains on sale will flow through to you as a trust beneficiary — but only to the extent of your annuity or unitrust payments. Example: \$500,000 capital gain, \$50,000 annual payout, maximum \$50,000 capital gain taxed to you each year for ten years. If the gain is large enough, you may defer tax permanently: you may die before all the gain flows through to you. If you do not name yourself or your spouse as a trust beneficiary, no capital gains will be taxed to you — instead those gains will flow through to the trust beneficiaries — but only to the extent of their annual annuity or unitrust payments.

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What part of the individual beneficiary's payment is taxed as long-term capital gain? That depends on the amount of the payment, as well as on the ordinary income, short-term capital gain, and long-term capital gain earned by the trust in the current year — or earned by the trust in prior years but not yet distributed. A “tier” system applies to characterize annuity or unitrust payments as coming:

- *first, from current and undistributed prior-year ordinary income;*
- *then, from current and undistributed prior-year short-term capital gain;*
- *then from current and undistributed prior-year long-term capital gain;*
- *then from current and undistributed prior-year tax-exempt income; and*
- *finally from corpus as a tax-free return of principal.*

Income or gain that is not distributed in the current year is held in reserve to be distributed in future years.

- You get a charitable income tax deduction when you fund the trust, based on charity's “remainder” interest in the trust, subject to all the normal income tax limitations on charitable deductions. If the contribution is very large, you may be able to take advantage of a five-year excess charitable contribution carry forward. If the designated charity is publicly supported (i.e. not a private foundation), your charitable deduction will be based on the fair market value of the contributed assets, whether appreciated publicly traded stock, appreciated closely held stock, or appreciated real estate.

- If you name yourself as beneficiary, you will receive cash flow from the trust during its term. Cash flow aside, the trust's investment yield may actually go up if it sells a highly appreciated but low-yielding asset and reinvests the proceeds in other, higher-yielding assets.

A CRT also provides a substantial benefit to the charity that will receive whatever amount remains in the trust at the end of its term. This amount may be greater or less than what you initially transferred to the trust. This will depend on the amount of your payout, whether it is recalculated each year (unitrust) or remains fixed (annuity trust), and how the trust investments actually perform.

### *How To Find Out More*

A CRT is an extremely flexible planning vehicle, and can be shaped to meet individual needs and objectives. It is important to explore all the alternatives, calculate the projected benefits of each, and decide whether a CRT is the right strategy for you. It is also important to be sure that both the trust document and its administration meet all the complex requirements of the tax law. The professionals at Northern Trust can help you and your attorney decide whether a CRT is the right choice for your personal financial plan.

*The foregoing discussion is general in nature and is intended for informational purposes only. Because the facts and circumstances surrounding each situation differ, you should consult your tax advisor and estate-planning professional before making any changes to your estate plan.*