Morgan Stanley

Charitable Remainder Trusts

Charitable Giving Strategies

A Charitable Remainder Trust (CRT) allows its creator/grantor to transfer an appreciated asset into the trust, sell it to diversify asset holdings, potentially defer capital gains tax consequences and benefit a charity of the grantor's choosing. With a CRT, the donor transfers property to a trust from which annual distributions will be made to the donor or one or more other individual designated non-charitable beneficiaries for a set period of time. At the expiration of the payment term, any assets remaining in the CRT are paid to the charitable beneficiary/beneficiaries and are not included in the grantor's federal taxable estate. The CRT is tax exempt, but the annual distributions to the non-charitable beneficiaries may be taxable income.

Wealth and Estate Planning Strategists
Family Office Resources

Description

The CRT is an irrevocable trust to which an individual (grantor) transfers assets and the trust makes a fixed payment (usually expressed as a percentage of trust assets), at least annually, to the grantor and/or family members or other individuals for a specified term. If anyone other than the grantor is to receive payments from the CRT during the payment term, then the grantor will be treated as making a gift to such person equal to the present value of that person's payment stream, computed by using the applicable government prescribed interest rate at the time the CRT is funded (referred to as the 7520 rate). The payment term can last for the life of the grantor and/or the life or lives of family members or other individuals. The payment term also can have a duration that lasts for a fixed number of years not exceeding twenty. At the end of the payment term, the remaining trust assets will pass to the charity or charities designated in the trust provisions

With all CRTs, the grantor can choose the desired annual payout percentage subject to the following rules: (i) the payout percentage cannot exceed 50%; (ii) the payout percentage cannot be less than 5%; and (iii) the present value of the charity's remainder interest cannot be less than 10% of the value of the property remaining for charity at the end of the payment term, determined at the funding of the trust and based on the fair market value of the trust's assets at that time..

CRATs and CRUTs

There are 2 types of CRTs. (i) A Charitable Remainder Annuity Trust (CRAT) pays the income beneficiary a fixed dollar amount each year, which must be at least 5% but not more than 50% of the initial market value of the assets contributed to the trust. (ii) A Charitable Remainder Unitrust (CRUT) pays the income beneficiary a fixed percentage of at least 5% but not more than 50% of the fair market value of the trust's assets as redetermined each year (the unitrust amount). As a result, trust assets are revalued each year so the payment amount from the CRUT probably will fluctuate from year to year. The duration of the payments can be a set amount of years (up to 20 years) or measured based on the lives of one or more of the trust's beneficiaries.

Income Tax

The income tax charitable deduction for a transfer to a CRAT is, generally, the difference between the value of the income beneficiary's present interest and the value of the property transferred to the trust. To calculate the income tax deduction, the donor must use an IRS discount rate which changes every month based on market conditions. The donor is allowed to use the discount rate for the month of the transfer or the two prior months, whichever produces the greatest deduction. The value of the charity's remainder interest must be at least 10% of the initial value of the trust property and CRATs are subject to a further requirement that there be less than a 5% probability of exhaustion of the trust corpus during the life of the income beneficiary. In general, the income tax deduction for the charitable remainder is subject to a limitation based on the donor's adjusted gross income (AGI). The limitation is based on the type of property contributed and the character of the ultimate charitable beneficiary.

Tiering

CRTs are generally not subject to income tax. However, the deferred income tax liabilities will pass to the non-charitable beneficiaries as part of their distributions and the character of the income is based on the income earned by the trust. Distributions from the CRT are deemed to occur in the following order: interest, dividends, qualified dividends, short-term then long-term capital gains, tax-exempt income and, finally, principal of the trust (tax-free).

Estate and Gift Tax

A donor who specifies an income beneficiary other than, or in addition to, the donor or his or her U.S. citizen spouse generally makes a taxable gift of the value of that beneficiary's interest. If the grantor dies during the term of the CRT, all or a portion of the trust assets may be included in the grantor's estate for federal estate tax purposes.

Private Foundation Rules

CRTs are subject to certain of the private foundation rules which impose excise taxes on acts of self-dealing between the CRT and persons considered related to it, and certain expenditures deemed inappropriate for tax purposes, and in some cases, owning too much of a business and investments that jeopardize the CRT's charitable purpose.

CRUT Variations

A CRUT can be structured so it pays the income beneficiary the lesser of the unitrust amount or trust's net income (which under certain circumstances can include realized capital gains). The CRUT can further be structured so that in years when net income exceeds the unitrust amount, the trust can be designed so that it pays the excess to the beneficiary to "make up" for years in which the trust accounting income was less than the unitrust amount. This "make-up amount" may be able to be paid from realized capital gains. A trust of this type is commonly referred to as a "deferred-income" CRUT. A "FLIPCRUT" is a deferred-income CRUT that "flips" into being a regular CRUT upon the happening of some specified event such as the sale of real estate contributed to the CRUT.

Advantages

If the grantor creates the CRT during life, the grantor will receive a federal gift tax charitable deduction and may receive a federal income tax charitable deduction, each being equal to the value of the property transferred to the CRT less the present value of the non-charitable beneficiaries' payment stream, computed by using the applicable 7520 rate. If the grantor creates the CRT at death, the grantor's estate will receive a federal estate tax charitable deduction equal to the value of the property transferred to the CRT less the present value of family's payment stream. Because CRTs are exempt from income tax, appreciated property contributed to a CRT can be sold without the current payment of any income tax, eg capital gains. A CRAT produces a steady distribution stream, which may be greater than that of the asset sold. When compared to an outright sale of an appreciated asset, use of a CRUT may, depending on the assumptions, increase the return to the donor because of the tax deferred compounding within the CRUT (and may also provide a benefit to charity). Use of a deferred-income CRUT may enhance such benefits because the tax deferral allows for greater compounding of the principal.

Disadvantages

At the end of the CRT payment term, the remaining trust assets will pass to charity and no longer be available to the non-charitable beneficiaries. CRT assets will only be available to the non-charitable beneficiaries in the form of a fixed payment stream over the specified payment term. As an irrevocable trust, the grantor cannot decide to terminate the CRT and take back the trust assets after the trust is funded. A CRT is subject to some of the private foundation excise tax rules. A CRT that has Unrelated Business

Taxable Income (UBTI) is subject to an excise tax equal to 100% of the amount of such UBTI (it no longer loses its tax exempt status for that year causing it to be taxed on all of its income for that year, as was the prior rule). UBTI is, for the most part, net income from a regularly carried on trade or business unrelated to the CRT's exempt purpose. UBTI can also include income generated by the use of borrowed funds. The donor's death during the CRT term can diminish the return from the CRT to the donor (to mitigate that risk, the distributions from the CRT can be used, for example, to pay premiums on insurance on the donor's life held by a separate trust which, if properly structured, can pass federal estate tax free on the donor's death).

Important Disclosure

Morgan Stanley Smith Barney LLC does not accept appointments nor will it act as a trustee but it will provide access to trust services through an appropriate third-party corporate trustee.

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