# Is a charitable trust right for you?

Wealth Management

## Why establish a charitable trust?

Charitable trusts are a popular way to fulfill philanthropic objectives. People contribute to a charitable trust for many different reasons, including:

- Desire to benefit a specific charity or area, such as arts or education
- Perpetuation of one's beliefs, values and ideals
- Desire to share one's "good fortune" with others
- Desire to reduce income and estate taxes
- Need to diversify investments without incurring immediate and substantial capital gains taxes
- Desire to increase annual income

## Which assets are best to donate?

Appreciated assets with low returns held for more than 12 months are the best assets to donate because the income tax deduction is based on the higher fair market value, rather than on the initial cost. As a tax-exempt entity, the trust can sell the assets without recognizing capital gains tax, leaving the full asset value available for reinvestment. Once the portfolio is diversified, the proceeds can very often be invested to produce income that exceeds previous income flows.

## Charitable remainder trusts (CRT)

A CRT is an irrevocable trust created by the individual who contributes the property. The trust makes payments to one or more non-charitable beneficiaries for life or for a predetermined number of years. At the termination of the income interest, a qualified charity receives the remaining assets of the trust.

## How are the distributions and tax deduction determined?

A special calculation is used to illustrate the options for the payout and tax deduction available based on the time horizon of the trust, the funding amount and the applicable federal rate.

Two types of CRTs are annuity trusts and unitrusts. In both cases, the minimum payout rate must be 5%. An annuity trust does not allow for additional contributions, while a unitrust does. Also, the income tax deductions are different.

The annual distribution from an annuity trust is a percentage of the initial contribution to the trust and will not change over the duration of the trust.

The annual distribution from a unitrust is based on the annual valuation of the trust assets and, therefore, the annual payment can fluctuate.

The income tax deduction is based on the present value of the contribution that the charity receives at the end of the term of the trust. The amount depends on the time horizon of the trust, the age of the beneficiaries, the rate of payout and the current applicable federal discount rate.

## How is a CRT taxed?

A CRT is generally treated as a tax-exempt entity. Therefore, the trust would typically not pay tax to the extent of any ordinary or capital gain income.

## How is the beneficiary taxed?

Income generated by a CRT that is passed through (distributed) to the non-charitable beneficiary is taxable according to a four-tier system. This four-tier system of taxation has a general "worst-in, first-out" (WIFO) rule. Therefore, the trust's ordinary income from the interest and dividends would be passed through prior to capital gains.

## Can I replace my child's inheritance?

Some donors use the income tax deduction and a portion of the annual payment to fund an insurance policy on the grantor's life. When an irrevocable life insurance trust owns the insurance policy, the death proceeds are exempt from estate tax. In this manner, heirs can be fully compensated for assets donated to charity.

## Which organizations qualify as "charitable?"

Qualified recipients are charitable organizations, such as not-for-profit schools, hospitals, churches and public charities. Private charitable foundations may also qualify.

## Who can be a non-charitable beneficiary?

Usually the grantor, grantor's spouse or grantor's children are the noncharitable beneficiaries. These individuals must be living when the trust is established.

## Who can be a trustee?

The donor can be a trustee, but careful drafting is necessary so you do not lose the benefits. Many grantors prefer to name an independent, professional trustee. A professional trustee can handle many of the complex issues surrounding this type of trust.

## Other charitable trust tools

Here are a few of the charitable trust tools in addition to CRTs:

- A charitable lead trust (CLT) provides an income to charity over a specified period. At the end of the period, the trust is dissolved and the remaining assets are distributed back to the donor or other named beneficiaries.
- Remainder interest in a residence arrangement enables a donor to transfer title of property to a charity, while continuing to occupy and enjoy the property for either the life of the tenants or a specified period of time.
- Family or private foundations and supporting organizations enable a donor to maintain a high level of control over donated assets. Private foundations are subject to a number of limitations and regulations. Supporting organizations have substantial benefits, including the ability to qualify for maximum charitable deduction.
- A donor-advised fund is much like a family foundation. It can be used as a vehicle for charitable gifts. Donor-advised funds are simple to set up and are public charities, so a gift to the fund qualifies for the maximum charitable deduction.

## What's my next step?

Charitable trust planning requires meeting and planning with an attorney. If a lifetime gift is made, the attorney drafts an irrevocable trust agreement. If the gift is made at death, the charitable trust provisions can be part of your will or living trust agreement.

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