Barrett Financial, Ltd.
Patrick Barrett
President
1019 Q Ave., Suite I
Anacortes, WA 98221
360-293-6287
360-770-4879
pat@barrettfinancialltd.com
www.barrettfinancialltd.com

What is Charitable Giving and Some Ideas

This information is provided as a guideline for what charitable giving is and how it may help with the funding of the Fidalgo Pool and Fitness Center Endowment Fund.

There are many ways to help fund this important project. We hope this information and the discussion that comes with it, will help you and your family determine how you can help... today and in the future.

Prepared for:
Friends of Fidalgo Pool and Fitness Center

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Charitable Gifting

What constitutes a gift to charity?

A gift to charity is simply a gratuitous transfer of property to a charitable organization. The key is that your gift must be some kind of property--your time or personal services do not count. There are several different types of property that can be donated to charity , and a gift is limited only by your imagination. Are you the type who wants to donate cash, stock, or your lunch box collection from a 1960s sitcom?

How do you decide whether to donate to charity?

The decision to donate to charity is a personal one. Although the IRS does not require that you have any charitable motivation when you donate to charity--you can do it strictly for the tax benefits--most people who decide to donate to charity have a charitable intent.

There are an infinite number of charities from which to choose. Most people have a particular charity in mind when they decide to make a contribution.

What are the tax benefits of donating to charity?

Through tax legislation, Congress has attempted to encourage charitable giving because it is good social policy. Most every charity depends on individual contributions to remain financially solvent, especially in this era of fewer direct government dollars. As a result, charitable giving has become interconnected with the tax laws, which have grown more and more complex.

Congress has sweetened the pot for taxpayers who donate to qualified charities . First, you generally receive an income tax deduction in the year you make the gift. Second, you do not have to worry about gift tax because federal gift tax does not apply to charitable gifts. Third, charitable gifts serve to reduce your taxable estate, thus reducing your potential estate tax liability. For more information, see Charitable Deduction . It is this last area--estate tax--where charitable giving may produce the greatest tax benefits. Over the next 30 years, an estimated $8 trillion of assets will pass from one generation to the next, resulting in the assessment of significant estate taxes. One solution to minimize these estate taxes is charitable giving.

What options do you have for donating to charity?

An outright gift

In the typical situation, your gift will be for the charity's benefit only, and the charity will take possession of the gift immediately. This type of gift is called an outright gift . This arrangement satisfies the general rule that a gift to charity must be paid to the charity in the form of money or property before the end of the tax year to be deductible for income tax purposes.

Split interest gift in trust

Another option is for your gift to be split between a charity and a noncharitable beneficiary. Here, one party (usually the noncharitable beneficiary) receives the use of the donated property for a specific period of time, which means he or she is paid a certain sum every year out of the donated property. Then, after this time period is up, the remaining property passes to the charity. Such gifts can be used to provide for a dependent child or a surviving spouse. In this arrangement, the charity's right to enjoyment and possession of the gift is delayed because the noncharitable beneficiary has the first interest in the donated property. Ordinarily, this delay would mean no tax deductibility for your gift. However, Congress has voiced its approval of such arrangements as long as the gift is set up as one of a number of special trusts expressly created for this purpose. If your split interest gift is set up as one of these trusts, you receive federal income, gift, and estate tax deductions.

CRAT (charitable remainder annuity trust)

A CRAT is a split interest gift between a noncharitable beneficiary and a charitable beneficiary. The noncharitable beneficiary has the first interest, and the charity has the remainder interest or second-in-line interest. The trust pays out a fixed amount of income every year (an annuity) to the noncharitable beneficiary for the term of the trust, and the remaining assets pass to the charity at the end of the term.

CRUT (charitable remainder unitrust)

A CRUT is a split interest gift between a noncharitable beneficiary and a charitable beneficiary. As with a CRAT, the noncharitable beneficiary has the first interest, and the charity has the remainder interest. However, instead of paying out a fixed amount each year, a CRUT pays the noncharitable beneficiary a fluctuating amount each year, depending on the value of the trust assets for that year. This amount is calculated as a percentage of the assets in the trust on a specified date each year. At the end of the trust term, the remaining assets pass to the charity.

Tip: *There are several varieties of CRUTs (* NI-CRUT , NIMCRUT *, or* Flip CRUT *), each with slightly different rules regarding how the noncharitable beneficiary is paid.*

Pooled income fund

A pooled income fund is a split interest gift between a noncharitable beneficiary and a charitable beneficiary. Like the CRAT and CRUT, the noncharitable beneficiary has the first interest and the charity has the remainder interest. A pooled income fund is managed by the charity (much like a mutual fund) and is made up of donations from several donors. The charity pays the noncharitable beneficiary a fluctuating amount each year, depending on the value of the fund in that year. These income distributions are made to the noncharitable beneficiary for his or her lifetime, after which the portion of the fund assets attributable to the noncharitable beneficiary is severed from the fund and used by the charity for its charitable purposes.

Charitable lead trust

A charitable lead trust is a split interest gift between a noncharitable beneficiary and a charitable beneficiary. Here, the charity has the first or lead interest and the noncharitable beneficiary has the remainder interest. The charity is paid a certain amount every year for the term of the trust, and then the remaining assets pass to the noncharitable beneficiary at the end of the trust term.

Bargain sale

A bargain sale in the context of charitable giving is a sale to charity at a bargain price (i.e., a price below the fair market value of the item sold, fair market value being the price a willing buyer would pay a willing seller in an arm's length transaction). The difference between the sale price and the actual fair market value of the asset equals your donation to charity. A bargain sale involves two separate transactions for tax purposes: a sale and a charitable gift. The IRS treats each event as a separate transaction. Consequently, each is reported separately on your income tax return.

Private foundation

Donors with sufficient resources may want to create a private foundation . A private foundation is a separate legal entity (often named for the donor) than can endure for many generations after the original donor's death. The donor creates the foundation, then transfers assets (typically appreciated assets) to the foundation, which in turn makes grants to public charities. The donor and his or her descendants retain complete control over which charities receive grants.

Community foundation

A type of organization related to a private foundation is called a community foundation . A community foundation concentrates its activities within a defined geographic area and is typically controlled by a representative group of community members, which may include the donor. In practice, a community foundation is a public charity, though it appears to share some of the characteristics of a private foundation.

Donor-advised fund

Similar in some respects to a private foundation, a donor-advised fund (DAF) offers an easier way for a donor to make significant charitable gifts over a long period of time. A DAF actually refers to an account that is held within a charitable organization. The charitable organization is a separate legal entity, but the donor's account is not--it is merely a component of the charitable organization that holds the account. Once the donor has transferred assets to the account, the charitable organization becomes the legal owner of the assets and has ultimate control over them. The donor can only advise--not direct--the charitable organization on how the donor's contributions will be distributed to other charities.

Charitable Deduction

What is the charitable deduction?

The charitable deduction allows you to deduct the value of property you give to charity from your estate and may reduce any federal gift and estate tax that may be owed. Charitable gifting allows you to satisfy your personal philanthropic desires and fulfill your estate planning objectives.

You may wish to give to the charitable community out of devotion, moral obligation, altruism, generosity, or a sense of responsibility. Or you may want to give because you believe you will do a better job of distributing your wealth than Uncle Sam. Whatever your motivation, charitable giving should be gratifying.

Gifts to charity can also fulfill your estate planning objectives. There are no limits on the amount that you can pass to charity. It is possible to transfer your entire estate to charity, tax free. Gifts to charity allow you to:

- Distribute your property tax free
- Potentially put the amount subject to estate taxes into a lower bracket

Caution: *However, remember that property you give to charity is property that does not go to your heirs. Don't let your attempt to save taxes have the unintended effect of depriving your heirs.*

Tip: Charitable gifts *are also deductible for income tax purposes for taxpayers who itemize. However, there is a limit imposed on the amount that can be deducted, and other adjustments may be required.*

How does a gift or bequest of property qualify for the charitable deduction?

Certain conditions and requirements must be met to qualify for this deduction:

- You must make the transfer, either during life or at death by will, rather than your executor or heirs
- The property must be transferred to a qualified charity for a charitable purpose. A qualified charity includes:

1. The United States, any state, the District of Columbia, and any local government
2. Certain religious, scientific, or charitable organizations
3. Certain veterans organizations
4. Certain fraternal organizations
5. An employee stock ownership plan if the transfer is a qualified gratuitous transfer of qualified employer securities

Caution: *Gifts or bequests to individuals, no matter how needy or worthy the individuals are, cannot qualify for the charitable deduction.*

Tip: *The IRS publishes a list of charitable organizations (the Cumulative List) to which gifts or bequests will qualify for this deduction. The IRS does not define what a qualifying charitable purpose is. However, it has issued Letter Rulings that discuss what has been allowed or disallowed, and it has privately ruled that charitable purpose means the same for gift tax and estate tax purposes as it does for income tax purposes. Generally, a charitable purpose means a public purpose, as opposed to a private purpose.*

- Depending on the year in which you die, the gift or bequest must be included in your estate for estate tax purposes. The amount of the deduction is the value of the property transferred, but the amount cannot exceed the value of the property that is required to be included in your estate.
- You must be a U.S. citizen or resident at the time you make the gift.

Tip: *A charitable deduction is allowed for nonresident noncitizens, but only certain types of charities qualify.*

- Generally, the gift must be a present interest--A present interest means that the donee (the person or organization you give to) has the unrestricted right to the immediate use, possession, or enjoyment of the property, or the income from the property, from the moment you make the gift. The deduction is not available to gifts of future interests in property.

***Technical Note:** "Future interests" is a legal term and includes reversions, remainders, and any other delayed interest that postpones the commencement of the use, possession, or enjoyment of the property, or income from the property.*

***Tip:** Gifts of future interests may qualify for the deduction if the gift is structured as a partial interest gift. Partial interest gifts (property rights given to both charitable and noncharitable interests, e.g., a trust paying income to charity, with the remainder going to noncharitable beneficiaries) may qualify for the deduction if the donated property is transferred to an IRS-approved form of charitable trust, such as a* charitable lead trust , charitable remainder trust, *or* pooled income fund *.*

How do you use the charitable deduction?

For lifetime gifts, the charitable deduction is allowed for the year in which the gift is made for federal gift tax purposes. You don't need to file an annual gift tax return if all gifts made for a given year fully qualify for the charitable deduction.

Special rules regarding the charitable deduction

The amount of the charitable deduction is limited to the amount of the transfer actually made. Special rules apply if the transfer to charity first must bear a portion of any estate taxes because of the calculation difficulties that arise. Estate taxes are a function of the charitable deduction and the charitable deduction is a function of the estate taxes.

***Tip:** The interrelated computation can be avoided by providing a specific bequest to the charity, instead of a gift from the residuary estate.*

An example of the use of the charitable deduction

***Example(s):** Ron is a small-business owner in the town where he was born and raised. He is a well-liked and respected member of the community. Ron feels he should give back to his community and donates money every year to support the town's zoo, hospital, library, children's center, church, and other local charities.*

***Example(s):** During the years 2007 through 2011, Ron gave $500,000 in total to different charities. Each year, Ron filed a gift tax return but paid no gift tax because the gift tax charitable deduction offsets his taxable gifts. Each year, Ron also filed an income tax return, reducing his taxable income by the amount of income tax charitable deduction allowed. Say Ron dies in 2013 and that his will provides for a charitable bequest in the amount of $100,000, with the residuary estate passing to his only nephew, James. Ron's executor reduces Ron's taxable estate by $100,000 (allowed by the estate tax charitable deduction), which then reduces the estate tax owed. Ron's executor pays the estate tax owed and then distributes the residuary estate to James.*

Charitable IRA rollover gifts

Donors over the age of 70½ can make tax-free charitable distributions of up to $100,000 directly from their IRAs in 2014.

Caution: *Unless extended by Congress, this provision for charitable IRA rollover gifts is not available after 2014.*

Donors who have reached age 70½ can direct amounts (subject to the aforementioned $100,000 limit) to charity in satisfaction of their minimum required distribution as long as the following requirements were met:

- The donor is age 70½ at the time the gift is made.
- The charitable gift is made directly from an IRA to the charity.
- An individual can give a maximum of $100,000 in 2014. A spouse can give an equal amount from his/her IRA.
- Individuals can make as many gifts in any amount to as many charities as desired as long as the total does not exceed $100,000 for 2014.
- The gift cannot be made in exchange for a charitable gift annuity or to a charitable remainder trust.
- The gift cannot be made to a private foundation, donor-advised fund, or supporting organization (as described in IRC Section 509(a)(3)).

Charitable Remainder Unitrust (CRUT)

What is it?

A charitable remainder unitrust, or CRUT, is a trust with both charitable and noncharitable beneficiaries. When the trust is created, the charity's interest in the trust assets is a "remainder interest," which means it is second in line to someone else's interest. For this reason, this trust is characterized as a remainder trust. A CRUT works like this:

- You transfer property to a trust. It can be most anything (cash, securities, real property, an original painting).
- You choose a qualified charity (a charity must be a "qualified" one in order for your contributions to be tax deductible).
- You designate a noncharitable beneficiary. This person can be anyone--you, your spouse, your mail carrier.
- You determine, within set guidelines, how much money the noncharitable beneficiary is to be paid each year out of the trust assets. IRS rules require this payment to be at least 5 percent, but no more than 50 percent, of the fair market value of the trust assets, which are revalued every year.
- You determine how long the trust will last. It can be for the life of the noncharitable beneficiary (or joint lives for multiple beneficiaries) or for a fixed period of years up to 20 years.
- At the end of the stated period of time, all the remaining trust assets pass to charity.

Example(s): *Rob decides to donate some money to his favorite crime-fighting charity. He transfers $200,000 to a CRUT and names his partner, Chet, the noncharitable beneficiary. Rob sets the payment rate at 10 percent and the life of the trust at 15 years. The result is that every year for 15 years, Chet will receive an annual payment equal to 10 percent of the value of the trust assets for that year. In the first year, Chet will receive $20,000, which is 10 percent of the fair market value of the trust assets for that year. In the second year, if the trust assets increase in value to $230,000, Chet will receive 10 percent of this amount, or $23,000. After 15 years, all the remaining money in the trust will pass to charity.*

The distinguishing feature of a CRUT is that the annual payment to the income beneficiary is directly linked to the value of the trust assets and thus fluctuates from year to year. When the trust assets increase in value, so does the annual payment to the income beneficiary. Also, new contributions to a CRUT are allowed. A CRUT can be established to take effect either during your life (a living or inter vivos trust) or at your death (a testamentary trust). A CRUT operates in an identical manner in either situation. The reasons you might choose one over the other include tax consequences and the ability to see your trust in operation. For example, in the living trust situation, you are entitled to an immediate income tax deduction for the present value of the remainder interest that will pass to charity. There are several variations in the world of CRUTs. In addition to the standard CRUT, there is the net income only charitable remainder unitrust (NI-CRUT), the net income with makeup charitable remainder unitrust (NIMCRUT), and the "flip" unitrust (Flip-CRUT). Unless otherwise noted, this discussion pertains to the standard CRUT.

Caution: *On March 30, 2005, the Treasury and the IRS announced that for CRUTs created on or after June 28, 2005, a donor's spouse may be required to sign an irrevocable waiver of his or her right to elect a statutory share of the donor's estate, and that failure to do so may result in the CRUT failing to qualify for tax exempt status, and the donor may be unable to take the initial income tax deduction. The Treasury and the IRS have since extended the safe harbor date of June 28, 2005, pending further guidance from the IRS. See IRS Rev. Proc. 2005-24 and Notice 2006-15 for more information, and consult a tax professional.*

When can it be used?

You want to donate to charity but want a noncharitable beneficiary to receive an income stream for life or a period of years

By establishing a CRUT, you can donate to your favorite qualified charity and reap some tax benefits while simultaneously retaining an income stream provided by the donated assets. The income stream is in the form of an annual payment that is a fixed percentage of the value of the trust assets for that year. The payment is made to your designated beneficiary at least once per year.

Strengths

Provides income tax deduction

When you establish a charitable remainder unitrust (CRUT) during your lifetime, you receive an immediate income tax deduction for the present value of the remainder interest that will pass to charity (assuming you itemize deductions). This deduction is available even though the charity may not benefit from your gift for many years. Your deduction is limited to 20 percent, 30 percent, or 50 percent of your adjusted gross income, depending on the type of charity and the type of property donated to charity (via the trust). However, any deduction that cannot be used because of the adjusted gross income limitations may be carried forward for up to five years.

Provides an income tax haven for assets that have appreciated substantially

There is no IRS rule that says you must be 100 percent charitably motivated to establish a CRUT. Thus, it's perfectly acceptable, and even preferable, to set up a CRUT and fund it with an asset that has appreciated substantially in value (for example, stock, a closely held small business, or real property). When the trust sells the asset, it pays no capital gain or income taxes on the sale. The trust can then invest the proceeds and provide you or your designated beneficiary with an income stream from a much larger principal than if you had sold the asset yourself and paid capital gain tax. The income beneficiary of the CRUT must include annual distributions in gross income.

Example(s): *Steve, a bachelor, owns $200,000 of stock in an apparel company that he purchased 20 years ago for $10,000. If he were to sell the stock now, he would owe capital gain tax of nearly $28,500 (assuming a capital gains tax rate of 15 percent and no other variables), leaving him only $171,500 to invest. Instead, Steve can set up a CRUT and use his stock to fund it. The trust can then sell the stock and reinvest the entire $200,000, which is exempt from capital gain tax.*

Caution: *At one time, creative individuals established CRUTs that sought to convert highly appreciated assets into cash while at the same time avoiding a substantial portion of tax on the gain. These CRUTs, called "accelerated CRUTs," had a short life (two or three years) and paid out a high percentage of the trust assets each year. With creative accounting practices, the income beneficiary received nearly the entire amount of the asset donated to the trust with only minimal capital gain tax. Accelerated CRUTs are no longer allowed under current law.*

Allows for the additional contribution of assets

The IRS allows you to contribute to a CRUT as often as you wish. So, if you fund your CRUT with a large amount of cash and then later decide you want to add your stamp collection, you can. The advantage is you can increase the annual payment to the income beneficiary by donating more assets to the trust, because the beneficiary's payment is based on the value of the trust assets. You can even "pour over" future bequests from your will into the CRUT.

Example(s): *Melissa establishes a CRUT with three prized paintings. Two years later, she writes her will and, among other provisions, specifies that her three prized statues are to be added to the CRUT. The result is that on her death, the statues will be added to the trust.*

Allows annual payment to increase when value of trust property increases

Because the annual payment is linked to the value of the trust assets, it can increase when the value of the trust property increases. The trust assets are revalued every year on the same date (the revaluation date), at which time the new payment for the year is determined. So an income beneficiary can benefit from a skilled trustee who, through wise investments, increases the value of the trust assets.

Provides you with positive social, religious, and/or psychological benefits for donating to your favorite charity

Yes, the tax benefits can be great. In addition, donating to charity can be a real morale booster.

Reduces potential federal estate tax liability

If all the requirements of a CRUT are met, the IRS allows the executor of your estate to deduct the present value of the remainder interest that will pass to charity from your gross estate. This will reduce the size of your gross estate. Essentially, once the value of the charity's interest is determined (using special IRS tax tables), the entire amount may be deducted from your gross estate.

Example(s): *In his will, Matt establishes a CRUT for the life of his friend Jill, with the remainder to go to an animal humane society. Assuming that the present value of the remainder interest to charity is $75,000, Matt's estate executor Dick will be entitled to subtract $75,000 from Matt's gross estate. However, the value of the income stream to be paid to Jill will be included in Matt's* *gross estate.*

Tradeoffs

Requires an irrevocable commitment

If you have any doubts about donating to charity, you should think twice before establishing a CRUT. Once you fund it, there's no turning back. You can't even amend a CRUT once the ink is dry and it's properly executed (though you can change the charity).

Assets donated to charity are assets lost to your family

Once you decide to donate a portion of your estate to charity with a CRUT, these assets are forever removed from your inheritable estate.

Tip: *This reality has prompted the creation of "wealth replacement trusts," so called because their purpose is to replace the wealth lost to your family. A wealth replacement trust is often an* irrevocable life insurance trust (ILIT) *. The idea is that the donor uses part of the income stream generated by the CRUT to pay premiums on a life insurance policy in an amount roughly equal to the amount to be passed to charity. The policy is then held in trust and distributed to the family on the donor's death (free of income tax), thus "replacing the wealth."*

Involves more complicated administration

The administration of a CRUT is more complicated than the administration of its sister, CRAT (charitable remainder annuity trust). For one thing, the IRS requires the trust assets to be revalued annually. Also, the trustee must account for and value any new property that is contributed to the trust.

Annual payment may decrease when value of trust property decreases

Because the annual payment is linked to the value of the trust property, it can decrease in amount when the trust property decreases in value due to poor investment performance.

Tip: *However, the IRS permits, but does not require, the invasion of principal (or capital gains) if the actual income earned by a CRUT in a given year is insufficient to meet the required payment. So, if the income beneficiary is your mother-in-law and she could use the money, the trustee has the ability to invade the principal.*

Value of charity's remainder interest at time of creation of CRUT must be at least 10 percent of trust assets

The present value of the remainder interest to charity must be at least 10 percent of the value of the property contributed to the trust as of the date of each contribution. This figure is determined by using special IRS tax tables, which take into account the age of the income beneficiary, the amount of trust assets, and the specified percentage rate. This rule prevents you from setting up a CRUT with payments over the life of a very young income beneficiary. In such a scenario, it is possible that by the time the income beneficiary died, there would be nothing remaining for the charity.

Example(s): *A 48-year-old donor would be prohibited from setting up a 9 percent CRUT for the donor's lifetime (assuming a 3 percent interest rate) because the remainder value for charity, using the IRS tax tables, would be only 9.933 percent.*

How to do it

Consult a competent legal advisor

A legal professional well versed in the area of charitable remainder unitrusts (CRUTs) should be consulted. A CRUT is subject to many technical requirements and must be drafted with the utmost care in order to gain favorable tax benefits. Often, additional advisors (such as tax professionals, accountants, and/or CERTIFIED FINANCIAL PLANNERS™) will be necessary to devise the best strategies and analyze the numbers.

Pick a noncharitable beneficiary

The noncharitable beneficiary can be you, a spouse, another family member, or a friend. You can pick more than one noncharitable beneficiary.

Tip: *If you and your spouse, or your spouse, are the only noncharitable beneficiaries, the interest transferred to your spouse qualifies for a gift tax or estate tax marital deduction.*

Caution: *If you set up a lifetime CRUT with a very young income beneficiary, make sure you satisfy the rule that the value of the charity's remainder interest at the time of the creation of the CRUT is at least 10 percent of the trust assets.*

Caution: *For a lifetime CRUT, if the noncharitable beneficiary is other than you or your spouse, you have made a gift for federal gift tax purposes, part of which may qualify for the annual gift tax exclusion. If you are the grantor and a beneficiary of the CRUT and die during the trust term, the CRUT will be included in your gross estate for federal estate tax purposes, but will generally qualify for a charitable deduction and, if your spouse is the only other noncharitable beneficiary, a marital deduction.*

Pick a charity you wish to donate to and verify that it is a "qualified charity"

The IRS allows you to deduct contributions only to qualified charities. Generally, qualified charities are those operated exclusively for religious purposes, educational purposes, medical or hospital care, government units, and certain types of private foundations. Every year, the IRS publishes a list of all qualified organizations in IRS Publication 78, commonly known as the " Blue Book. " Check to make sure your charity is listed in this publication.

Tip: *Once you have picked a charity, IRS regulations require you to choose an alternate charity in case the one you picked is not in existence when the trustee is to deliver the trust assets.*

Tip: *Once you have picked a charity, it is a good idea to contact the charity to make sure it is willing to accept such a gift.*

Tip: *Alternatively, the IRS does not require you to pick a charity when the CRUT is established. You can thus set up a fully operational CRUT and reserve the choice of charity for a future date. However, the trust must set forth the specifics of when and how the charity will be identified. Be sure the charity you ultimately pick is a qualified one.*

Identify the asset(s) you want to use to fund the trust

You can use any type of property to fund the trust (e.g., cash, securities, real property, life insurance, a rare collectible in excellent condition).

Caution: *While you can use any type of property to fund the trust, restrictions associated with certain types of property may effectively prevent their use. For example, stock in a closely-held business is often subject to a buy-sell or other agreement that restricts to whom the stock can be transferred. As another example, certain types of trusts are not able to be S corporation shareholders; effectively, this means you would not be able to fund a CRUT directly with S corporation shares.*

Tip: *It is preferable to transfer an asset that has appreciated substantially in value because the trust is exempt from capital gain tax on the sale of any property.*

Tip: *Most CRUTs pay the income beneficiary on a quarterly basis, in which case the beneficiary will begin receiving income a few months after the CRUT's inception. This arrangement can pose problems for the trustee. If the asset you use to fund the trust takes some time to sell, the trustee will not have the cash available to pay the beneficiary. So, it is a good idea to fund the CRUT, at least in part, with marketable securities and/or cash. You don't want to place a parcel of real estate in the trust and assume a quarterly payment will be forthcoming to the beneficiary.*

Tip: *If you name yourself trustee of your CRUT, or if the noncharitable beneficiary or a related party (as defined by the IRS) is the trustee, the IRS requires you to obtain a "qualified appraisal" for all "unmarketable assets." Unmarketable assets are those that are not cash, cash equivalents, or marketable securities (e.g., a closely held business or real property). This rule is to prevent self-dealing in the appraising of hard-to-value assets.*

Set the annual valuation date for the trust assets

The trust assets are revalued once every year on the same date. This is called the "valuation date," and it is set in the trust document. IRS regulations allow the unitrust amount to be paid within a reasonable time after the close of the year. Consequently, you can pick December 31 as your annual valuation date.

Determine how long the trust will be in existence and set the payment rate

You control the duration of the trust. The trust can be in existence for the life of the noncharitable beneficiary (or joint lives for multiple beneficiaries) or for a fixed period of years up to 20 years. The payment rate is set as a specified percentage of trust assets, which are revalued every year. Once the percentage amount is set, it remains the same over the life of the trust. It must be at least 5 percent, and no more than 50 percent, of the fair market value of the trust assets for that year.

Caution: *Once you establish the duration of the CRUT and the payment rate, you must analyze the numbers to make sure you comply with the rule that the present value of the charity's remainder interest be at least 10 percent of the trust assets.*

Select a trustee

Once an asset has been transferred to a CRUT, it is the trustee's responsibility to manage, invest, and conserve this property. The trustee has a dual fiduciary responsibility: to generate income for the noncharitable beneficiary and to preserve the trust assets for the charity. It helps to choose a trustee who is experienced and well versed in the area of CRUTs.

Tip: *If you want to appoint the charity as trustee, it is a good idea to contact the charity to make sure it is willing to serve in this capacity.*

Caution: *You can appoint yourself trustee. However, you are then responsible for investing the assets to produce income sufficient to make the required payment to the income beneficiary. In addition, as trustee, you are required to keep abreast of and comply with new IRS regulations on CRUTs in order to gain favorable tax benefits. You are also responsible for valuing all new property donated to the trust.*

Tip: *If you are both trustee and income beneficiary, some states require that a cotrustee be appointed who is not a beneficiary.*

Coordinate the CRUT with your existing will and/or living trust

It is a good idea to make sure your CRUT is coordinated with any other estate planning documents to achieve an integrated plan. A competent professional should undertake this review.

File Form 5227--Split Interest Trust Information Return

Even though a CRUT is exempt from federal income tax, you must still file Form 5227 (Split Interest Trust Information Return) every year the CRUT is in existence. Further, if it is your first year filing Form 5227, you must also include a copy of the trust instrument and a written declaration that the document is a true and complete copy.

Tax considerations

Income Tax

Income tax deduction for donor of charitable remainder unitrust (CRUT) established during donor's lifetime

If you itemize deductions, the IRS allows you to take an immediate income tax deduction for the present value of the remainder interest that will pass to charity. You are entitled to receive the deduction in the year that you establish the CRUT, even though the charity may not benefit from your gift for several years.

Your allowable deduction for the given year is limited to either 50 percent, 30 percent, or 20 percent of your adjusted gross income (AGI), depending on the type of property donated to charity (via the trust) and the classification of the charity as either a public charity or a private foundation. If you cannot take the full deduction in the given year, you may carry over the difference for up to five succeeding years (assuming you still itemize deductions in those years).

Tip: *Generally, a "public charity" is a publicly supported domestic organization, whereas a "private foundation" does not have the same broad base of public support. IRS Publication 78 notes whether a charity is a public or private one.*

Technical Note: *The amount of your deduction is calculated using special interest rate tables established by the IRS. The current rules require the value of a remainder interest to be calculated in a certain fashion. It is calculated by using an interest rate that is 120 percent of the federal midterm rate then in effect for valuing certain federal government debt instruments for the month the gift was made. In addition, the calculation uses the most recent mortality table available to determine the mortality factor. Special computer programs now exist to make this calculation easier.*

Example(s): *Tammy, a 67-year-old woman, places $250,000 in a CRUT. She designates herself income beneficiary for life and sets an annual payment of 9 percent of the trust assets, with payments to be made quarterly (at the end of each period). Assuming a 3 percent interest rate (using the IRS tax table described above), her allowable income tax deduction using the tax tables is $73,390. If Tammy's AGI for the year is $80,000 and her charity was a public charity (allowing for a 50 percent deduction), Tammy will have an allowable income tax deduction of $40,000 for the current year. The remaining $33,390 (the difference between her authorized deduction and her allowed deduction) is then carried over to subsequent years. In the second year, Tammy can deduct $33,390 (assuming her AGI remains the same and she still itemizes deductions).*

Income tax consequences for income beneficiary of CRUT

If you are the income beneficiary of a CRUT, you will owe income tax on any income payments you receive. So, although a CRUT can escape capital gain tax on the sale of an asset, this benefit does not pass on to you. You must pay income tax on any part of this income that is distributed to you.

The IRS uses a special accounting procedure to determine the tax on the income distributed to you.

Gift Tax

No gift tax if you and/or your spouse are sole beneficiaries

If you and/or your spouse are the only income beneficiaries of a CRUT, you do not owe gift tax. The income stream to your spouse falls under the unlimited marital deduction .

Caution: *In community property states, husband and wife are treated as equal owners. If community property is used to fund a trust that benefits only one spouse or if separate property of one of the spouses is used to fund a trust that provides lifetime benefits to both parties, there is a recognized gift to the other spouse. This may have implications under the particular state's gift tax law.*

Possible gift tax if someone other than spouse is beneficiary

If the income beneficiary of a CRUT is someone other than you or your spouse or in addition to you or your spouse, gift tax rules come into play. The present value of the income stream to the beneficiary is determined at the time the gift is established. If the value is more than the $14,000 (in 2014 and 2015) annual gift tax exclusion , a gift tax must be paid, unless a portion of your applicable exclusion amount ($5,430,000 in 2015) is available to offset the tax due.

Caution: *Any portion of the gift tax applicable exclusion amount you use during life will effectively reduce your estate tax applicable exclusion amount that will be available at your death.*

Estate Tax

Reduces size of gross estate

One of the best features of a CRUT is its ability to reduce the size of your gross estate. When you establish a testamentary CRUT, the executor of your estate can deduct the present value of the remainder interest being left to charity from your gross estate. The smaller your gross estate, the less chance you have of owing estate tax.

Example(s): *Gary establishes a testamentary CRUT. Assume that at his death, the present value of the charity's remainder interest is determined to be $150,000 (using special IRS tax tables). Consequently, the executor of Gary's estate will be entitled to deduct $150,000 from his gross estate.*

Caution: *If you are the grantor and a beneficiary of the CRUT and die during the trust term, the CRUT will be included in your gross estate for federal estate tax purposes, but will generally qualify for a charitable deduction and, if your spouse is the only other noncharitable beneficiary, a marital deduction.*

Questions & Answers

Can you establish a charitable remainder unitrust (CRUT) and name yourself the sole income beneficiary?

Yes, you can be both the donor and the sole income beneficiary. However, once you establish a CRUT, it must still be irrevocable, even if you are the income beneficiary.

Can you name more than one income beneficiary?

Yes, you can name more than one income beneficiary. However, if you create a CRUT with a life term for each beneficiary, you may run afoul of the rule requiring the present value of the remainder interest to charity to be at least 10 percent of the trust assets. For example, a husband and wife, each 50 years old, would be disqualified from establishing a CRUT for their lives if the annual payment amount were more than about 6.6 percent of the trust assets.

Can you choose more than one charity as the charitable beneficiary?

Yes, you can choose more than one charity as the remainder beneficiary, as long as the trust document sets forth your right to do so and specifies how the trust assets will be distributed. Of course, you must make sure that the second (or third or fourth) charity constitutes a "qualified organization" under IRS rules. Otherwise, you risk losing favorable tax treatment.

Can you replace the trustee during the life of the CRUT?

Yes. As long as the trust agreement provides for it, you can replace the trustee.

You are the income recipient of a CRUT. How does the IRS determine the income tax you will pay on this distribution?

The extent to which the payment is taxable depends on the character of the payment, which in turn is determined under a special income tax calculation formula unique to charitable remainder trusts. Charitable remainder trusts include charitable remainder annuity trusts (CRATs) and CRUTs.

Technical Note: *The IRS uses a four-tier accounting procedure, also called the "ordering rules," to determine the tax character of the income distribution to the beneficiary. The acronym used to describe this accounting rule is WIFO, which stands for "worst in, first out." The amounts distributed by a CRUT are classified as follows:*

- Ordinary income, to the extent of ordinary income earned by the trust in the current year, along with any undistributed ordinary income from prior years (ordinary income includes dividends)
- Capital gain (including qualified dividends), to the extent of the capital gains earned by the trust in the current year, along with any undistributed capital gain from prior years
- Nontaxable income, to the extent of the nontaxable income earned by the trust in the current year, along with any undistributed nontaxable income from prior years
- Principal

The highest tax the IRS imposes is on ordinary income. If the required annual payment cannot be paid out of ordinary income, it is then paid from capital gains. If the payment still cannot be met after exhausting capital gains, it is paid from tax-exempt income and finally, if necessary, from the principal of the trust.

Tip: *The trustee must keep track of all sales and gains by the trust in order to make these calculations. This is a daunting task often completed by a computer tracking system. This is one more reason to question whether you really want to appoint yourself trustee.*

Also, the IRS cares about the type of property you use to fund the CRUT. If you contribute nonappreciated property (like cash), the payment to the income beneficiary constitutes a return of principal, and no income tax is due. By contrast, if you contribute appreciated property (like stock), the payment from principal has income tax consequences for the income beneficiary. The income tax will be in the form of a capital gain tax to the extent that any part of the payment is attributable to gains that were untaxed prior to the asset being transferred to the trust. In other words, the donated asset carries with it the tax characteristics that existed prior to the asset being transferred to the CRUT.

What is an "accelerated CRUT?"

An accelerated CRUT is no longer permitted under current law. Under prior law, an accelerated CRUT was a standard CRUT with an extremely short term (two or three years) and an "accelerated" payout. It was funded with an asset that had appreciated substantially in value. Using creative accounting practices, the donor got back as much value of the asset as possible, free of capital gain tax.

Example(s): *Ron sets up a CRUT in January of year one with $500,000 of stock he purchased 20 years ago for $50,000. Ron designates himself income beneficiary, sets the life of the trust for two years, and sets the annual payout rate at 80 percent. Suppose that in year one, the trustee does not sell the stock. Thus, the trust has no income for year one. Ron, however, is still owed a payment of $400,000 (80 percent of $500,000). Under old IRS rules, the trustee was allowed to pay the income beneficiary "within a reasonable period of time after the close of the taxable year." So here's where the creative accounting comes into play. In January of year two, the trustee sells the stock and receives $500,000. Shortly thereafter, the trustee pays Ron $400,000 to satisfy the year one payout requirement. The trustee also makes a separate payment to Ron of $80,000, which is the required payout for year two (80 percent of the remaining $100,000). At the end of year two, the remaining $20,000 passes to charity.*

Example(s): *Here is the result based on a literal reading of the ordering rules the IRS uses to characterize income paid out to an income beneficiary. The $400,000 payout in year one is classified as a return of principal because the trust did not have any current or prior undistributed ordinary income, capital gain, or tax-exempt income in year one (because the trustee had not yet sold the stock). So Ron enjoys the entire $400,000 free and clear of all taxes. The $80,000 payout in year two is treated as capital gains income (because the trust had capital gains income in year two from the sale of stock), so Ron must pay a capital gain tax of $12,000 (15 percent x $80,000, assuming no other variables). The end result is that through the trust, Ron has sold a $500,000 asset with a $50,000 cost basis and ended up with $468,000 in cash (as well as a charitable contribution deduction in year one). By contrast, if Ron had sold the stock himself, he would have owed higher capital gain taxes.*

Recently, the IRS implemented a new regulation that has effectively shut down this accelerated CRUT technique. Specifically, the IRS now requires all CRUTs and CRATs (charitable remainder annuity trusts) to distribute the annual payment to the income beneficiary in the taxable year when the payment is due.

So, in the above example, the trustee would have had to pay out $400,000 in year one. To do so, the trustee would have had to sell the stock, thus generating capital gain income in the same year as the distribution. So the $400,000 would be subject to capital gain tax.

Only standard CRUTs and CRATs are affected by this rule. Thus, NI-CRUTs (net income charitable remainder unitrusts) and NIMCRUTs (net income with makeup charitable remainder unitrusts) will still be allowed to make any required payment to the income beneficiary within a reasonable time after the close of the taxable year.

What are the advantages of using a CRUT over a CRAT (charitable remainder annuity trust)?

Although a CRAT and CRUT are both charitable remainder trusts, there are differences between them. A CRAT pays out to the income beneficiary a fixed amount every year for the life of the trust. The amount is set as a percentage of the trust assets, which are valued only once at the inception of the CRAT. If the amount cannot be paid from the current income earned by the trust, the principal must be invaded. By contrast, a CRUT pays out a fixed percentage of the value of the trust assets every year, which is determined on an annual basis. So the payment fluctuates with the value of the assets. A CRUT will often provide that if the payment cannot be paid from the current income earned by the trust, the principal may, but need not be, invaded. If the trust assets appreciate substantially, the noncharitable beneficiary will receive a greater payout. Second, once a CRAT is funded, additional contributions of property are prohibited. By contrast, new property can be added to a CRUT. These differences make the CRUT more complicated and more difficult to administer.

Charitable Remainder Annuity Trust (CRAT)

What is it?

A charitable remainder annuity trust, or CRAT, is a trust with both charitable and noncharitable beneficiaries. When the trust is created, the charity's interest in the trust assets is a "remainder interest," which means it is second in line to someone else's interest. For this reason, this trust is characterized as a remainder trust. A CRAT works like this:

- You transfer property to a trust. It can be most anything (money, securities, real property, a statue).
- You choose a qualified charity (a charity must be a "qualified" one in order for your contributions to be tax deductible).
- You designate a noncharitable beneficiary. This person can be most anyone (you, your spouse, a friend).
- You determine, within set guidelines, how much money the noncharitable beneficiary is to be paid each year out of the trust assets (called the annuity rate). IRS rules require this payment to be at least 5 percent, but no more than 50 percent, of the initial fair market value of the trust assets.
- You determine how long the trust will last. It can be for the life of the noncharitable beneficiary (or joint lives for multiple beneficiaries) or for a fixed period of years up to 20 years.
- At the end of the stated period of time, all the remaining trust assets pass to charity.

Example(s): *Frank decides to donate some money to the XYZ Charity. He transfers $100,000 to a CRAT and names his wife as the noncharitable beneficiary. Frank decides the annuity rate will be 7 percent and that the trust will last for 10 years. The result is that every year for 10 years, Frank's wife will receive an annual payment of $7,000, which is 7 percent of $100,000 (the initial fair market value of the trust assets). After 10 years, all of the remaining money in the trust will pass to the XYZ Charity.*

The distinguishing feature of a CRAT is that the annual payment is a fixed amount that remains the same over the life of the trust. The payment is based on the initial fair market value of the trust assets, which are valued only once at the creation of the trust. This is significant because the payment amount cannot be changed later to account for new circumstances, such as an increase in the value of the trust assets, inflation, or a change in the income requirements of the noncharitable beneficiary. A CRAT can be established to take effect either during your life (a living or inter vivos trust) or at your death (a testamentary trust). A CRAT operates in an identical manner in either situation. The reasons you might choose one over the other include tax consequences and the ability to see your trust in operation. For example, in the living trust situation, you are entitled to an immediate income tax deduction for the present value of the remainder interest that will pass to charity. See the Tax Considerations section of this discussion.

Caution: *On March 30, 2005, the Treasury and the IRS announced that for CRATs created on or after June 28, 2005, a donor's spouse may be required to sign an irrevocable waiver of his or her right to elect a statutory share of the donor's estate, and that failure to do so may result in the CRAT failing to qualify for tax exempt status, and the donor may be unable to take the initial income tax deduction. The Treasury and the IRS have since extended the safe harbor date of June 28, 2005, pending further guidance from the IRS. See IRS Rev. Proc. 2005-24 and Notice 2006-15 for more information, and consult a tax professional.*

When can it be used?

You want to donate to charity but want a noncharitable beneficiary to receive an income stream for life or a period of years

By establishing a CRAT, you can donate to your favorite qualified charity , reap some tax benefits, and, at the same time, retain control over an income stream derived from the donated assets. The income stream is in the form of a fixed payment, which in turn is based on the initial value of the trust assets. The payment amount is set by you and paid to your designated beneficiary at least once per year.

Strengths

Provides income tax deduction

When you establish a CRAT during your lifetime, you receive an immediate income tax deduction for the present value of the remainder interest that will pass to charity. This deduction is available even though the charity may not benefit from your gift for many years.

Provides an income tax haven for assets that have appreciated substantially

There is no IRS rule that says you must be 100 percent charitably motivated to establish a CRAT. Yes, you heard it right. Thus, it's perfectly acceptable, and even preferable, to set up a CRAT and fund it with an asset that has appreciated substantially in value (for example, stock, a closely held business, or real estate). When the trust sells the asset, it pays no capital gain or income taxes on the sale. The trust can then invest the proceeds and provide you or your designated beneficiary with an income stream off of a much larger principal than if you had sold the asset yourself and paid capital gain tax.

Example(s): *Gary owns $100,000 of stock that he purchased 20 years ago for $5,000. If Gary were to sell the shares, he would owe capital gain tax of nearly $15,000 (assuming a capital gain tax rate of 15 percent and no other variables) leaving him only $85,000 to invest. Instead, Gary can set up a CRAT and use his stock to fund it. The trust can then sell the stock and reinvest the entire $100,000, which is exempt from capital gain tax.*

Pays out fixed income every year

Many older income beneficiaries want the security and consistency of a fixed payment every year.

Caution: *A fixed payment cannot be increased in future years. So, even if the trust assets increase in value or a long period of inflation sets in, the payment remains fixed over the life of the CRAT.*

Exists with fairly simple administration

The annual payment to the noncharitable beneficiary is set at the creation of the CRAT and remains fixed over the life of the trust. It is based on the fair market value of the trust assets, which are valued only once at the inception of the trust. Thus, there are no time-consuming annual valuations of the trust property. Once a CRAT is funded, no additional contributions of property are permitted.

Provides you with positive social, religious, and/or psychological benefits for donating to your favorite charity

Yes, the tax benefits can be great. In addition, donating to charity can be a real morale booster.

Reduces potential federal estate tax liability

If all the requirements of a CRAT are met, the IRS allows the executor of your estate to deduct the present value of the remainder interest that will pass to charity from your gross estate. This will reduce the size of your gross estate. Once the value of the charity's interest is determined (using special IRS tax tables), the entire amount may be deducted from your gross estate.

Example(s): *In her will, Kathy establishes a CRAT for the life of her friend, Paige, with the remainder to go to a local charity fighting illiteracy. Assuming that the present value of the remainder interest to go to charity is $125,000, Paige's estate will be entitled to subtract $125,000 from her gross estate.*

Tradeoffs

Requires an irrevocable commitment

If you harbor reservations about leaving a portion of your estate to charity, you shouldn't jump to establish a CRAT. Once you fund it, there's no turning back. You can't even amend a CRAT once the ink is dry and it's properly executed, although you can give the trustee the discretion to choose the exact charitable beneficiary at the end of the term.

Assets donated to charity are assets lost to your family

Once you decide to donate a portion of your estate to charity with a CRAT, these assets are forever removed from your inheritable estate.

Tip: *This reality has prompted the creation of "wealth replacement trusts," so called because their purpose is to replace the wealth* *lost to your family. A wealth replacement trust is often an* irrevocable life insurance trust (ILIT) *. The idea is that the donor uses part of the income stream generated by the CRAT to pay premiums on a life insurance policy in an amount roughly equal to the amount to be passed to charity. The policy is then held in trust and distributed to the family on the donor's death (free of estate tax), thus "replacing the wealth."*

Requires the fixed annuity to be paid each year, regardless of whether there is sufficient trust income available

IRS rules require that if the income from the trust (dividends, gains, and/or interest) is insufficient to meet the required annual payment to the noncharitable beneficiary, then the difference must be paid from capital gains or principal. A drastic result means the charity could end up with nothing.

Example(s): *Suppose the trust asset is an apartment house and the rents are the income from which the annual payment is made. If the rents were to fall below the required payment amount, the trustee would have to borrow against the property or, even worse, sell the property to make the required payment.*

Inflation may cause a CRAT to lose some of its value

The trust assets are valued only once at the creation of the CRAT, and the fixed annual payment is based on this valuation. Because the payment remains the same over the life of the trust, it cannot be adjusted for inflation. Thus, the purchasing power of a fixed income stream may be eroded by inflation.

Tip: *Despite this potential problem, older income beneficiaries often prefer a CRAT because they want to plan on a fixed amount of income each year.*

Prohibits the additional contribution of assets

Once a CRAT is funded, IRS rules prohibit you from making any additional contributions. Thus, it is impossible to "pour over" future bequests from your will into the trust.

Value of charity's remainder interest at inception of CRAT must be at least 10 percent of trust assets

The present value of the remainder interest to charity must be at least 10 percent of the fair market value of the trust property as of the date the property is contributed to the trust. This present value is determined by using special IRS tax tables, which take into account the age of the income beneficiary, the amount of trust assets, and the fixed annuity rate. This rule prevents you from setting up a CRAT with payments made over the life of a very young income beneficiary or with a very high payout rate and an older beneficiary. In such scenarios, it is possible that by the time the income beneficiary died, there would be nothing left for the charity.

Example(s): *This rule would prohibit a client from setting up a CRAT for 10 years with a payment rate of 10.6 percent and an interest rate of 3 percent because the remainder value for charity (using the tax tables) would be only 9.58 percent.*

Income beneficiary cannot have more than 5 percent chance of outliving trust assets

This rule is otherwise known as the 5 percent probability test. It is a test devised by the IRS to discourage fraud and has no relation to the rule that at least 5 percent of the trust assets must be paid out to the income beneficiary every year. The 5 percent probability rule states that an income beneficiary cannot have more than a 5 percent probability of outliving the trust assets. Otherwise, there would be no assets left for the charity. This probability is determined using actuarial tables and takes into account the age of the noncharitable beneficiary, the amount of trust assets, and the payout rate.

How to do it

Consult a competent legal advisor to draft the charitable remainder annuity trust (CRAT)

A legal advisor well versed in the area of charitable remainder annuity trusts (CRATs) is your best bet. A CRAT is subject to many technical requirements and must be drafted with the utmost care in order to gain favorable tax benefits. Often, additional advisors (such as tax specialists, accountants, life insurance experts, and/or CERTIFIED FINANCIAL PLANNERS™) will be necessary to devise the best strategies and "crunch the numbers."

Pick a noncharitable beneficiary

The noncharitable beneficiary can be you, a spouse, another family member, or friend. You may choose practically anyone, as long as there is not more than a 5 percent chance that the noncharitable beneficiary will outlive the trust assets.

Tip: *If you and your spouse, or your spouse, are the only noncharitable beneficiaries, the interest transferred to your spouse qualifies for a gift tax or estate tax marital deduction.*

Caution: *For a lifetime CRAT, if the noncharitable beneficiary is other than you or your spouse, you have made a gift for federal gift tax purposes, part of which may qualify for the annual gift tax exclusion. If you are the grantor and a beneficiary of the CRAT and die during the trust term, the CRAT will be included in your gross estate for federal estate tax purposes, but will generally qualify for a charitable deduction and, if your spouse is the only other noncharitable beneficiary, a marital deduction.*

Pick a charity you wish to donate to and verify that it is a "qualified charity"

The IRS allows you to deduct contributions only to "qualified charities." Generally, qualified charities are those operated exclusively for religious purposes, educational purposes, medical or hospital care, government units, and certain types of private foundations. Every year, the IRS publishes a list of all qualified organizations in IRS Publication 78, commonly known as the "Blue Book." Check to make sure your charity is listed in this publication.

Tip: *Once you have picked a charity, IRS regulations require you to choose an alternate charity in case the one you picked is not in existence when the trustee is to deliver the trust assets.*

Tip: *Once you have picked a charity, it is a good idea to contact the charity to make sure it is willing to accept such a gift.*

Tip: *Alternatively, the IRS does not require you to pick a charity when the CRAT is established. So, you can set up a fully operational CRAT and reserve the choice of charity for a future date. However, the trust must set forth the specifics of when and how the charity will be identified. Be sure the charity you ultimately pick is a qualified one.*

Identify the asset(s) you want to use to fund the trust

You can use any type of property to fund the trust (e.g., cash, securities, real property, life insurance, a prized stamp collection).

Tip: *Because the trust is exempt from capital gain tax on the sale of any property, it is preferable to transfer an asset that has appreciated substantially in value.*

Tip: *It is a good idea to fund the CRAT, at least in part, with marketable securities and/or cash. You don't want to transfer real estate to the trust and assume it can be sold in time to make the required payment to the income beneficiary.*

Determine how long the trust will be in existence and set the payment rate

You control the duration of the trust. The trust can be in existence for the life of the noncharitable beneficiary (or joint lives for multiple beneficiaries) or for a fixed period of years up to 20 years. The payment rate (also called the annuity rate) is the amount of money paid to the noncharitable beneficiary each year. It is a fixed amount that does not change during the life of the trust. It must be at least 5 percent, and no more than 50 percent, of the initial fair market value of the trust assets. IRS regulations allow the payment to be made within a reasonable time after the close of the year.

Caution: *Once you have established the duration of the trust and the payout rate, you must "crunch the numbers" to make sure you comply with the IRS rule that the present value of the charity's remainder interest equals at least 10 percent of the total trust assets.*

Select a trustee

Once you transfer an asset to a CRAT, it is the trustee's responsibility to manage, invest, and conserve this property. The trustee has a dual fiduciary responsibility: to generate income for the noncharitable beneficiary and to preserve the trust assets for the charity. It helps to choose a trustee who is well versed in the world of CRATs.

Tip: *If you want to appoint the charity as trustee, it is a good idea to contact the charity to make sure it is willing to serve in this capacity.*

Caution: *You can appoint yourself trustee. However, you are then responsible for investing the assets to produce income sufficient to meet the requirements of the trust. If the trust income is insufficient to make the required payment to the income beneficiary, you must invade the principal to make up the difference. Frequent dips into principal may mean an early demise of the entire CRAT. Another pitfall is that the IRS periodically updates the requirements of a CRAT. As trustee, you will need to keep abreast of these regulations and comply with them in order to gain favorable tax benefits.*

Caution: *If you are both the trustee of the CRAT and the income beneficiary, some states require that a co-trustee be appointed who is not a beneficiary.*

Coordinate the CRAT with your existing will and/or living trust

It is a good idea to make sure your CRAT is coordinated with any other estate planning documents to achieve an integrated plan. A competent professional should undertake this review.

File Form 5227--Split Interest Trust Information Return

Even though a CRAT is exempt from federal income tax, you must still file Form 5227 (Split Interest Trust Information Return) every year the CRAT is in existence. Further, if it is your first year filing Form 5227, you must also include a copy of the trust instrument and a written declaration that the document is a true and complete copy.

Tax considerations

Income Tax

Income tax deduction for donor of charitable remainder annuity trust (CRAT) established during donor's lifetime

If you itemize deductions, the IRS allows you to take an immediate income tax deduction for the present value of the remainder interest that will pass to charity. You are entitled to the deduction in the year you establish the CRAT, even though the charity may not benefit from your gift for several years.

Your deduction for the given year is limited to 50 percent, 30 percent, or 20 percent of your adjusted gross income (AGI), depending on the type of property donated to charity (via the trust) and the classification of the charity as either a public charity or a private foundation. If you cannot take the full deduction in the given year, you may carry over the difference for up to five succeeding years (assuming you still itemize deductions in those years).

Tip: *Generally, a "public charity" is a publicly supported domestic organization (e.g., the Red Cross), whereas a "private foundation" does not have the same base of broad public support (e.g., the Rockefeller Foundation). IRS Publication 78 notes whether a charity is a public or private one.*

Technical Note: *The amount of your deduction is figured using special interest rate tables established by the IRS. The current rules require the value of a remainder interest to be calculated in a certain fashion. It is calculated by using an interest rate that is 120 percent of the federal midterm rate then in effect for valuing certain federal government debt instruments for the month the gift was made. In addition, the calculation uses the most recent mortality table available to determine the mortality factor. Special computer programs now exist to make this calculation easier.*

Example(s): *Helen, an 80-year-old woman, places $100,000 in a CRAT, designating herself income beneficiary for life and setting a fixed annual payment of 5 percent, or $5,000. Assuming a 3 percent interest rate (using the IRS tax table described above), her allowable income tax deduction would be $64,960. If Helen's AGI for the year was $80,000 and her charity was a public charity (allowing for a 50 percent deduction), Helen would have an allowable income tax deduction of $40,000 for the current year. The remaining $24,960 (the difference between her authorized deduction and her allowed deduction) could then be carried over to the following year and deducted in full.*

Income tax consequences for income beneficiary of CRAT

If you are the income beneficiary of a CRAT, you will owe income tax on any payments you receive out of the income. So, although a CRAT can escape paying capital gain tax on the sale of an asset, this benefit does not trickle down to you, so you must pay income tax on any part of the income that is distributed to you.

The IRS uses a special accounting procedure to determine the tax on the income distribution to you.

Gift Tax

No gift tax if you and/or your spouse are sole beneficiaries

If you and/or your spouse are the only income beneficiaries of a CRAT, you do not owe gift tax. The income stream to your spouse falls under the unlimited marital deduction .

Caution: *In community property states, husband and wife are treated as equal owners. If community property is used to fund a CRAT that benefits only one spouse or if separate property of one of the spouses is used to fund a CRAT that provides lifetime benefits to both parties, there is a recognized gift to the other spouse. This may have implications under the particular state's gift tax law.*

Possible gift tax if someone else is beneficiary

If the income beneficiary of a CRAT is someone other than you or your spouse (or in addition to you or your spouse), gift tax rules come into play. The present value of the income stream to the beneficiary is determined at the time the gift is established. If the present value is more than the $14,000 (in 2014 and 2015) annual gift tax exclusion , gift tax must be paid, unless a portion of your applicable exclusion amount (in 2015, $5,430,000 plus any deceased spousal unused exclusion amount) is available to offset the tax due.

Caution: *Any portion of the applicable exclusion amount you use during life will effectively reduce the amount that will be available at your death.*

Estate Tax

Reduces size of gross estate

One of the best features of a CRAT is its ability to reduce the size of your gross estate (and thus any potential estate tax). When you establish a testamentary CRAT, the executor of your estate can deduct the present value of the remainder interest payable to charity from your gross estate. The smaller your gross estate, the less chance you have of owing estate tax.

Example(s): *Ken sets up a testamentary CRAT, naming his friend the lifetime income beneficiary and ABC Charity the charitable beneficiary. Assume that at Ken's death the present value of the remainder interest to ABC Charity is valued at $200,000. The result is that the executor of the estate will be entitled to deduct $200,000 from Ken's gross estate.*

Caution: *If you are the grantor and a beneficiary of the CRAT and die during the trust term, the CRAT will be included in your gross estate for federal estate tax purposes, but will generally qualify for a charitable deduction and, if your spouse is the only other noncharitable beneficiary, a marital deduction.*

Questions & Answers

Can you establish a charitable remainder annuity trust (CRAT) and name yourself the sole income beneficiary?

Yes, you can be both the donor and the sole income beneficiary. However, once you establish a CRAT, it is still irrevocable, even if you are the income beneficiary.

Can you choose more than one charity as the charitable beneficiary?

Yes, you can choose more than one charity as the remainder beneficiary, as long as the trust document sets forth your right to do so and specifies the manner that the trust assets will be distributed. Of course, you must make sure that the second (or third or fourth) charity constitutes a "qualified organization" under IRS rules. Otherwise, you risk losing favorable tax treatment.

Can you choose more than one income beneficiary?

Yes, you can name more than one income beneficiary. However, if you create a CRAT with a life term for each beneficiary, you may run afoul of the rule requiring the present value of the remainder interest to charity to be at least 10 percent of the trust assets. So make sure to crunch the numbers when picking more than one income beneficiary.

Can you replace the trustee during the life of the CRAT?

Yes. As long as the trust agreement provides for it, you can replace the trustee.

You are the income recipient of a CRAT. How does the IRS determine the income tax you will pay on this distribution?

The extent to which the payment is taxable depends on the character of the payment, which in turn is determined under a special income tax calculation formula unique to charitable remainder trusts. Charitable remainder trusts include charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs) .

The IRS uses a four-tier accounting procedure to determine the tax character of the income distribution to the beneficiary. The acronym used to describe this accounting rule is WIFO, which stands for "worst in, first out." The amounts distributed by a CRAT are classified as follows:

- Ordinary income, to the extent of ordinary income earned by the trust in the current year, along with any undistributed ordinary income from prior years (ordinary income includes interest)
- Capital gain (including qualified dividends), to the extent of the capital gains earned by the trust in the current year, along with any undistributed capital gains from prior years
- Nontaxable income, to the extent of the nontaxable income earned by the trust in the current year, along with any undistributed nontaxable income from prior years
- Principal

The highest tax the IRS imposes is on ordinary income. If the required annual payment cannot be paid out of ordinary income, it is then paid from capital gains. If the payment still cannot be met after exhausting capital gains, it is paid from tax-exempt income and finally, if necessary, from the principal of the trust.

Tip: *The trustee must keep track of all sales and gains by the trust in order to make these calculations--a daunting task often completed by a computer tracking system. This is one more reason to question whether you really want to appoint yourself trustee.*

Also, the IRS cares about the type of property you use to fund the CRAT. If you contribute nonappreciated property (like cash), the payment to the income beneficiary constitutes a return of principal, and no income tax is due. By contrast, if you contribute appreciated property (like stock), the payment from principal has income tax consequences for the income beneficiary. The income tax will be in the form of a capital gain tax to the extent any part of the payment is attributable to gains that were untaxed prior to the asset being transferred to the trust. In other words, the donated asset carries with it the tax characteristics that existed prior to the asset being transferred to the CRAT.

What are the advantages of using a CRAT over a CRUT (charitable remainder unitrust)?

Although a CRAT and CRUT are both charitable remainder trusts, there are differences between them. A CRAT pays out to the income beneficiary a fixed amount every year for the life of the trust. The amount is set as a percentage of the trust assets, which are valued only once at the inception of the CRAT. If the amount cannot be paid from the current income earned by the trust, the principal must be invaded. By contrast, a CRUT pays out a fixed percentage of the value of the trust assets every year. The value of the trust assets is determined on an annual basis. So the payment fluctuates with the value of the assets. A CRUT will often provide that if the payment cannot be paid from the current income earned by the trust, the principal may, but need not be, invaded. Second, once a CRAT is funded, additional contributions of property are prohibited. By contrast, new property can be added to a CRUT. These differences make the CRUT more complicated and more difficult to administer.

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Barrett Financial, Ltd.
Patrick Barrett
President
1019 Q Ave., Suite I
Anacortes, WA 98221
360-293-6287
360-770-4879
pat@barrettfinancialltd.com
www.barrettfinancialltd.com