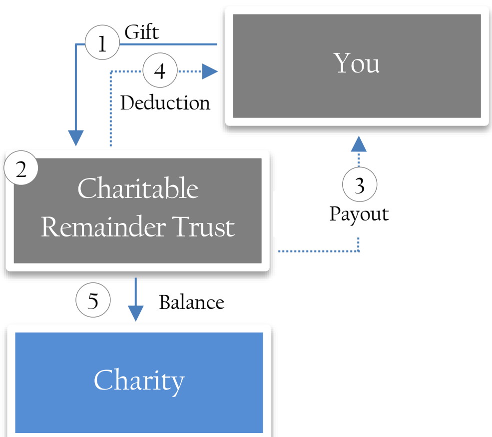
CAPITAS FINANCIAL
Charitable Remainder Trusts

OVERVIEW

A charitable remainder trust (CRT) lets you make a substantial charitable gift now while retaining a defined income stream from the donated assets. The CRT is primarily a charitable-giving strategy with an added benefit — it lets you sell appreciated assets in the trust without incurring immediate capital gains taxes.

HOW DOES IT WORK?



1. You transfer property to an irrevocable charitable trust.
2. Because the CRT is a charitable trust, it does not pay income taxes. When the trustee sells the property contributed to the CRT, the trust does not incur capital gains taxes. In many cases, the trustee will sell the assets originally contributed to the trust and reposition them in a diversified portfolio designed to provide the desired income stream to the donor(s).
3. The trust pays you a defined income stream for life. (If you are married, this payout can continue for the lives of both spouses.)
4. Because you made an irrevocable gift to charity, you are entitled to an income tax deduction in the year you make the donation. The deduction is based on the "present value" of the future gift to charity.
5. After the last income beneficiary's death, any remaining principal is distributed to the charity or charities that you selected. You can retain a right to change the charitable beneficiary.
6. Because trust assets pass to a charity, their value is effectively removed from your taxable estate.

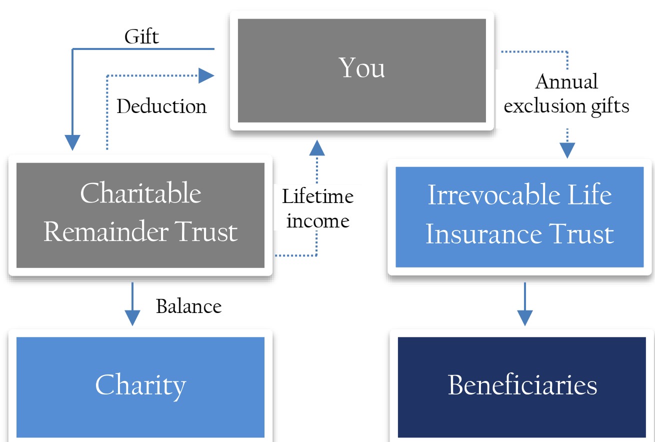
There are two principal types of CRT; each uses a different method for determining the payout to the donor.

With a charitable remainder annuity trust ("annuity trust" or "CRAT"), the payout to the donor is a fixed dollar amount each year determined as a percentage of the original contribution to the trust. For example, if you contribute $1 million and your trust calls for a 6% payout, you would receive $60,000 per year. You would receive the same payout for the duration of the trust, regardless of changes in the fair market value of the trust principal. Tax law does not permit additional contributions to an annuity trust.

With a charitable remainder unitrust ("unitrust" or "CRUT"), the payout is a fixed percentage of the fair market value of trust assets determined as of a particular day each year (usually the first or last day of the year). This means that the payout will vary each year as the trust assets increase or decrease in value. A donor may make additional contributions to a unitrust.

Combining your charitable gift with a "wealth replacement" strategy

When you create a CRT, your heirs will receive less when you die because the trust assets will go to charity. In many cases, however, donors use an additional strategy to replace some or all of the transferred wealth. Here's how it works:



In addition to creating a CRT, you also create an irrevocable life insurance trust ("insurance trust" or "ILIT"). The ILIT is designed so that the trust assets will not be included in your taxable estate. Typically, you make annual gifts to the ILIT using some or all of your after-tax income from the CRT. The ILIT trustee, in turn, can use these funds to acquire life insurance on you. (For married couples, a second-to-die policy is often used.) When you die, all remaining funds in the CRT go to charity. At the same time, the proceeds from the life insurance policy will be paid into the ILIT, which is designed to benefit your beneficiaries.

It is very important to have life insurance in force before you make an irrevocable gift to the CRT. This wealth replacement strategy's effectiveness may vary depending on your particular situation. At least one of the donors must qualify for life insurance. Every situation is different. It's important to work with your Financial Advisor to evaluate whether a wealth replacement strategy is a good fit in your particular circumstances.

HOW IS IT IMPLEMENTED?

Because establishing a CRT involves important legal and tax decisions, it's essential to work closely with your attorney and CPA. They can help you determine whether a CRT makes sense for your situation. Both should be involved in the design process; your attorney can draft the trust document, and your CPA can help you understand the tax implications. You select the trustee, and the trustee will be responsible for managing trust investments.

FREQUENTLY ASKED QUESTIONS

Is there a limit on how much income I can receive?
Yes. Both tax rules and practical considerations may limit the payout to the donor.

- For a trust to qualify as a CRT, it must be designed so that the income tax deduction (measured as the present value of the charity's interest) is at least 10% of the total value contributed.
- Annuity trusts are subject to an additional limitation. If there is more than a 5% probability that the charity will receive nothing, the trust will not qualify.
- These rules are applied using IRS-mandated statistical methods. Your tax advisor should make these calculations.
- As a practical matter, if the payout exceeds the total return on trust investments, trust principal will be depleted. It's important to work with your Financial Advisor to select a realistic payout rate for your age, circumstances and objectives.

How will I be taxed on the payout from a CRT?
It's common for some of the payout to be taxed as ordinary income and some as capital gains. Although the CRT itself does not pay tax, tax regulations account for trust income in four "layers":

- The first layer consists of the trust's ordinary income (including both regular income and qualified dividends).
- The second layer consists of the trust's realized capital gains (including any gain realized when the trustee sells assets contributed to the trust).
- The third layer consists of tax-free income (such as municipal bond income) received by the trust.
- The fourth and last layer is a return of principal.

Distributions are made in order, beginning with the first layer. For example, to the extent that the trust received ordinary income and qualified dividends, distributions are first characterized as ordinary income and qualified dividends. Next, distributions are characterized as capital gains until all capital gains ever realized by the trust are distributed. Very often, CRTs are funded with appreciated assets, and a large capital gain is realized when those assets are sold and diversified. As a result, it is uncommon for distributions to reach the third or fourth layer.

Distributions characterized as investment income are subject to the 3.8% Medicare Net Investment Income Tax (NIIT) once the beneficiary's modified adjusted gross income exceeds $200,000 (single) or $250,000 (married filing jointly). These thresholds are fixed and are not indexed for inflation.

If I fund a CRT near year-end, will I receive a full year's payout?
No. The payout is prorated for the portion of the year that the trust exists.

How is my income tax deduction determined?
The deduction is determined using IRS-mandated statistical methods and tables. In general: (1) older donors get a higher deduction, (younger donors receive a smaller deduction) and (2) lower payouts mean a higher deduction (higher payouts result in a lower deduction). Each month, the IRS announces the discount rate (called the "Section 7520 rate"), which must be used in these present-value calculations.

Are there limits on how much of a deduction I can use?
Yes, there are many tax rules that could affect how you benefit from a charitable deduction. For example:

- If your CRT benefits a public charity: Your maximum charitable deduction in any one year for gifts of cash is 60% of your adjusted gross income (AGI) minus deductions for all other contributions. The 60% limit applies through 2025 and is scheduled to revert to 50% beginning in 2026 unless Congress acts. If you give appreciated assets with a long-term holding period (including marketable securities), your deduction is limited to 30% of AGI. Unused deductions may be carried forward for up to five years.
- If your CRT's beneficiary is (or can be) a private foundation: Your maximum charitable deduction in any one year for gifts of cash is 30% of your AGI. If you give marketable securities, your deduction is limited to 20% of AGI. For other types of appreciated assets, your deduction may be limited to your cost basis. These rules apply any time a private foundation is a permissible beneficiary of a CRT. Unused deductions can be carried forward for up to five years.

- The “Pease” overall limitation on itemized deductions is suspended through 2025 but is scheduled to return in 2026
- For gifts of real estate, the charitable deduction may be reduced to the extent of depreciation previously taken.
- Charitable deductions may be limited for individuals subject to the alternative minimum tax (AMT).

Always work closely with your tax advisor to determine how a proposed strategy would affect your tax situation.

Can I change the charitable beneficiary?
Yes, if the trust document is drafted to give you this option.

Who can be the trustee?
You have several choices:

- You can be your own trustee. You must understand that the funds in the CRT are no longer yours and that you have a legal obligation to manage the trust in a way that gives equal weight to the interests of the charitable beneficiary and yourself. Your CPA and attorney can help you understand the tax and legal implications of acting as your own trustee.
- You can name the charity as trustee. Consider, however, that the charity may ask you to give up your right to change the charitable beneficiary or replace the trustee.
- You can name an independent corporate trustee. A corporate trustee provides the benefit of a professional staff with a great deal of experience in managing charitable trusts.

Can I make my own private foundation the beneficiary of my CRT?
Yes. Note that if a private foundation is a permissible beneficiary of a CRT, then the CRT becomes subject to several special tax rules, just as if the CRT itself were a private foundation. Talk with your tax advisor to learn more about how these rules might affect your CRT.

Can my CRT continue to pay income to my children after my death?
Theoretically yes, but be sure to consider the income-, estate- and gift-tax consequences.

- If the secondary beneficiary is younger than you, your charitable deduction could be limited or the trust may not qualify.
- The present value of the child’s future interest will either be a current taxable gift or includible in your taxable estate. Assets in the CRT cannot be used to pay any gift tax or estate tax due. This can impose a financial burden on the individuals responsible for paying the tax.

I don’t need income from the CRT now but would like to get income later. Can I do that?
Possibly. There are two types of charitable remainder unitrusts (CRUTs) that may fit in this situation. Both may require the payment of some income during the initial years of the trust; it may not be feasible to defer all income until later.

- In a “flip” unitrust (sometimes called a “flip-CRUT”), the trust initially pays you the lesser of current income or a unitrust payout (a stated percentage based on the value of trust assets). The trust also defines a “trigger” event. After the trigger event occurs, the trust switches (or “flips”) to a standard unitrust payout. The triggering event must be something outside of your control. For example, the flip could be triggered after a specific time or when an independent trustee sells real estate or some other nonmarketable asset contributed to the trust.
- In a net income with makeup charitable remainder unitrust (sometimes called a NIMCRUT), the trust pays the lesser of current income or a stated unitrust payout but may eventually let you “make up” for past low-income years. In years when current income is less than the stated unitrust payment, the trustee keeps track of the shortfall. If current income is higher than the stated unitrust payout in future years, the trustee will pay out the higher amount to the extent that it will “make up” for past shortfalls.

These are complex strategies, and their success may depend on events or market conditions that are outside your control. When considering or implementing either of these strategies, it is essential to work closely with your attorney and CPA.

I own a stock that is the target of a merger or tender offer. If the deal goes through, I will incur a capital gain. Can I put the stock in a CRT and avoid being taxed?
Possibly, but this depends on the specific facts and circumstances. In general, if you transfer shares to a CRT when a merger is proposed but not yet a “done deal” or if it is uncertain whether sufficient shares will be tendered, you may be able to avoid the capital gain. On the other hand, if at the time you transfer shares the merger is essentially certain to happen or if enough shares have already been tendered to assure acceptance of the tender offer, then it is too late to avoid being taxed on the capital gain. In these situations, it’s essential to work closely with your tax advisor.

Can I fund a CRT with real estate or shares in a closely held business?
Potentially yes, although many special considerations come into play. For example:

- Business assets or debt-financed real estate may not be favorable assets to donate. Tax regulations treat income from a business or debt-financed real estate as "unrelated business taxable income," which may be subject to a 100% penalty tax if held in a CRT.
- An independent third-party appraisal will be required to establish the market value of the business interest or real estate at the time of the gift.
- A trustee may require environmental or other inspections before agreeing to accept real estate or business property.
- If you want to avoid a capital gain upon the sale of the asset, you must irrevocably contribute the asset to the CRT before engaging in any substantial negotiations to sell it. If you fund the CRT after you have begun to negotiate the sale, you will not avoid capital gain taxes.
- The CRT must make payouts as called for by the trust's terms. If the donated business interest or real estate does not produce sufficient cash flow, it may be necessary to design the CRT as a "flip unitrust" or NIMCRUT, which could mean reduced or no payments until after the business interest or real estate is sold.

Before donating this type of asset, work closely with your attorney and CPA and be sure you understand all of the tax and practical implications. This type of gift can work in the right circumstances but must be carefully planned and executed.

Can I fund a CRT with an annuity, an IRA or retirement plan asset?

Historically, a lifetime transfer of IRA or qualified-plan assets into a CRT would trigger immediate income tax on the entire amount. SECURE 2.0 (effective 2023) created a once-per-lifetime Qualified Charitable Distribution of up to $50,000—indexed for inflation ($54,000 in 2025)—that an IRA owner age 70 ½ or older may roll to a newly created CRAT or CRUT. The trust must meet special requirements (for example, a maximum 5% payout and only the IRA owner and/or spouse as income beneficiaries).

For larger lifetime transfers the traditional rule still applies, and the distribution would be taxable. At death, IRA or plan assets can instead be left to a CRT, avoiding immediate income tax and providing a life or term income to heirs under the CRT payout rules.

How does a CRT compare to a charitable-gift annuity or pooled-income fund?

A CRT is an advanced charitable-planning technique that is usually used for relatively large charitable gifts. A CRT may not be feasible for smaller gifts because of the costs of creating and administering a trust. The charitable-gift annuity and pooled-income fund are two "turnkey" charitable strategies that can provide a life income to the donor and may work for somewhat smaller gifts.

In all three of these techniques, you make an irrevocable donation to a charity; you get a partial tax deduction at the time you make the gift; and the charity agrees to pay you income for your lifetime. But the method for determining the payout to the donor is different with each technique:

- With a pooled-income fund, the charity "pools" the assets from various donors, and the income you get is based on your share of the current income (basically, dividends and interest) earned by assets in the pool. Your income can vary from year to year based on the type and performance of assets in the pool. Contrast this to a CRT, in which your payout is either a fixed dollar amount or a fixed percentage of the trust's value. The income you receive from a pooled-income fund will either be ordinary income or qualified dividends; there is no capital gain component.
- With a charitable-gift annuity, the charity agrees to pay you a fixed dollar amount for life. In some ways, this is like a charitable remainder annuity trust (CRAT). There is no "unitrust" option for charitable-gift annuities. It is important to understand that the promise to pay is simply an unsecured obligation of the charity; it is not insured or guaranteed. The income you receive from a charitable-gift annuity is often partly ordinary income, partly capital gain and partly a nontaxable return of principal. The tax effects on you vary based on the payout rate, your age and your cost basis in the donated assets. Some charities also offer deferred gift annuities, which pay nothing for a period of time and then begin to pay income at a defined point in the future.
