Understanding Charitable Remainder Trusts

There are many benefits to be gained from donating to charity, aside from the warm fuzzy it gives you. It cannot only give you a tax deduction, but also another possible benefit: cash flow. A charitable remainder trust is one way to give to charity and potentially increase your cash flow. Here's how a Charitable Remainder Trust works:

An individual donates an asset (usually a highly appreciated asset) to a charitable trust. The asset is sold while in the trust and reinvested in an income-producing portfolio. The individual (plus any other non-charitable beneficiary) receives cash flow for life equal to (1) a a fixed percentage of the value of the asset each year (charitable remainder unitrust- "CRUT"), or (2) a fixed dollar amount (charitable remainder annuity trust- "CRAT"). In either case, the individual also receives an immediate tax deduction equal to the fair market value of the asset minus the present value of the estimated future income stream, using IRS approved computation. There are no capital gains taxes due upon the sale of the asset inside the trust. A portion of the stream of income can be used to purchase life insurance to benefit the heirs (with tax-free proceeds) since the charity will ultimately receive the principal of the trust.

A Charitable Remainder Trust accomplishes several goals. First, it provides an opportunity to assist a favorite charity. Second, it can turn a non-income producing asset into an income-producing asset. Third, it reduces income and estate taxes. Finally, it helps add diversification to a financial portfolio and capital gains taxes are bypassed.

Let's take Fred and Ethel for example. Fred and Ethel, both 65, are ready to retire and move to Florida. They have stock with a fair market value of $750,000; an adjusted cost basis of $230,000 and annual dividends of $20,000. This stock represents 80 percent of their portfolio, and they are concerned about the lack of diversification. By donating the stock to a charitable trust benefiting their favorite charity (The Lucy Foundation), the trust can sell the stock and purchase a diversified portfolio of assets. Fred and Ethel will receive an income from the trust of about 6% ($45,000), which will be paid to them every year for life. They will also receive an income tax deduction of about $235,000 in the year of the gift, avoid the capital gains on the appreciated value of the property ($750,000-230,000), and more than double their income while diversifying the portfolio. Although Fred and Ethel have no children, they would like to provide an inheritance for their Godson, little Ricky. By taking a portion of their increased cash flow and purchasing life insurance in the amount of $750,000 (the donated amount), they can pass the life insurance benefits outside of their estate, and therefore, estate tax-free to little Ricky.

Of course, this brief article is no substitute for a careful consideration of all of the advantages, and disadvantages of this matter in light of your unique personal circumstances. Before implementing any significant tax or financial planning strategy, contact your financial planner, attorney or tax advisor as appropriate.

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