WEALTH MANAGEMENT INSIGHTS

# Charitable Remainder Trusts


**Schwab Center for Financial Research**

Austin Jarvis, JD
Director


## Key Takeaways

- Using charitable remainder trusts, high-net worth individuals can support their favorite charities and generate an income stream for themselves or another beneficiary.
- Donating to charities in this way allows the donor to possibly receive an income tax deduction, defer capital gains taxes, and receive a gift or estate tax deduction.
- Charitable remainder trusts should only be created by those who have charitable intent.

## Overview

A charitable remainder trust (CRT) allows a donor, otherwise known as the grantor, to make a tax-deductible gift to charity while generating income for life or a set number of years. At the end of the specified term, the remaining trust assets pass to one or more designated charities. The grantor may receive an immediate income tax deduction for the remainder interest (subject to limitations), may defer capital gains tax on the sale of the donated assets, and at death, the estate may receive a gift or estate tax deduction for the remainder interest.

## Who is it for?

A CRT is most appropriate for high-net worth individuals or families who have highly appreciated assets or property they would like to turn into an income stream in a tax-efficient manner and have a desire to benefit a charity or charities of their choice.

### Advantages

- Convert appreciated assets into an income stream for the grantor for life or a set number of years.
- Reduce concentrated positions without immediate capital gains consequences.
- Immediate income tax deduction for the actuarial value of the charity's remainder interest.
- Reduce potential estate tax exposure and receive creditor protection for assets moved to a CRT.
- Reduce or defer capital gains tax exposure.
- If a CRT is a beneficiary of an IRA, the payout period to a designated beneficiary can be longer than the 10 years required by the SECURE Act.

### Disadvantages

- Transfers made to a CRT are irrevocable.
- Sizeable assets are needed to make a CRT worthwhile.
- Additional costs for trust creation and maintenance.
- The income beneficiary only has access to the annuity or unitrust payments, not the trust assets. No additional payments can be made, no matter the need.
- The income beneficiary may have to pay income taxes.

### Charitable remainder trusts come in two types.

There are two primary types of CRTs: the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT). Both types must provide a payout to the non-charitable beneficiary at least annually. CRATs do not allow additional contributions to be made after initial set-up. However, because CRUTs are revalued each year, additional contributions are allowed. A CRT may remain in existence for a beneficiary's lifetime or for a specified period of time not to exceed 20 years.

For both types of CRTs, the present value of the remainder interest passing to charity at the end of the CRT term must be at least 10% of the fair market value of the property contributed as of the date of contribution.

**CRATs.** With a CRAT, the current, non-charitable, income beneficiary (typically the grantor) receives a fixed annuity amount each year. The amount of the annuity can either be a percentage of the CRAT or a fixed dollar amount *based on the initial gift*. The annuity payout cannot be less than 5% or exceed 50% of the value of the trust assets.

**CRUTs.** With a CRUT, the current, non-charitable, income beneficiary (typically the grantor) receives a percentage of the fair market value of the trust assets (the "unitrust amount") each year. The assets are revalued annually, so the income payout *may change each year*. The unitrust amount cannot be less than 5% or exceed 50% of the fair market value of the trust assets.

### What are the tax implications?

**Income taxation of the CRT.** Generally, a CRT is exempt from income tax, unless the trust has unrelated business income (UBTI). UBTI results when the trust has income from a trade or business owned by the charity, but not substantially related to its charitable purpose. If a CRT has UBTI, the UBTI will be subject to a 100% excise tax.

**Income taxation of the donor.** The grantor/donor of a CRT can generally take an income tax charitable deduction for the actuarial value of the designated charity's remainder interest.

The value of the charitable remainder interest is calculated based on three variables: (1) the statutory interest rate issued by the U.S. Treasury Department each month, known as the "section 7520 rate," (2) the duration of the income term (i.e., either a fixed term or the life expectancy of the income recipient), and (3) the annuity or unitrust income percentage rate.

**Income taxation of the non-charitable income beneficiary.** The Internal Revenue Code uses an ordering procedure to determine the tax character of the payments to income beneficiaries: (1) ordinary income, (2) capital gains (the capital gains subject to

**Mechanics of a Charitable Remainder Trust**


1. Grantor(s) transfer appreciated asset or property to the Charitable Remainder Trust and receives a federal income tax deduction for the present value of the charity's remainder interest, subject to limitations.
2. Trustee of the CRT sells the asset or property, paying no capital gains. The proceeds from the sale are invested.
3. Trustee pays the grantor(s), or other non-charitable beneficiary, an income for life or for a term of years. Federal and state income taxes may apply.
4. When the CRT terminates, the remaining trust assets go to one or more designated charities selected by the grantor(s). Estate may receive charitable deduction for estate taxes.

Source: SCFR. For illustrative purposes only.

the highest rate deemed distributed first), (3) other income (typically tax-exempt), and (4) principal. If there is more than one recipient of the income distribution, each recipient will receive a pro rata share of each category.

**Gift and estate taxes.** If a CRT is created during the grantor's life, gift taxes may apply if there are income beneficiaries other than the grantor and/or his or her spouse. Similarly, estate taxes may apply upon the creation of a testamentary CRT if there are income beneficiaries other than the surviving spouse ?

## Case study

The grantor/donor is a 60-year-old widow in the 37% tax bracket in 2022, who owns real estate with a fair market value of $1 million and a cost basis of $250,000. If the grantor sold her property, federal capital gains taxes (23.8% rate) would be $178,500 ($750,000 x 23.8%). Instead, the grantor, working with her trusted legal, financial, and tax advisors, creates a CRAT as follows:

**Trust term:** 20 years

**Funding amount:** $1,000,000

**Presumed growth of trust:** 5.5%

**Annuity payout rate:** 5%

**IRS discount rate (7520):** 2.2%

**Annual amount to grantor:** $50,000

**Projected amount to charity:** $1,174,342

**Income tax deduction:** $197,990

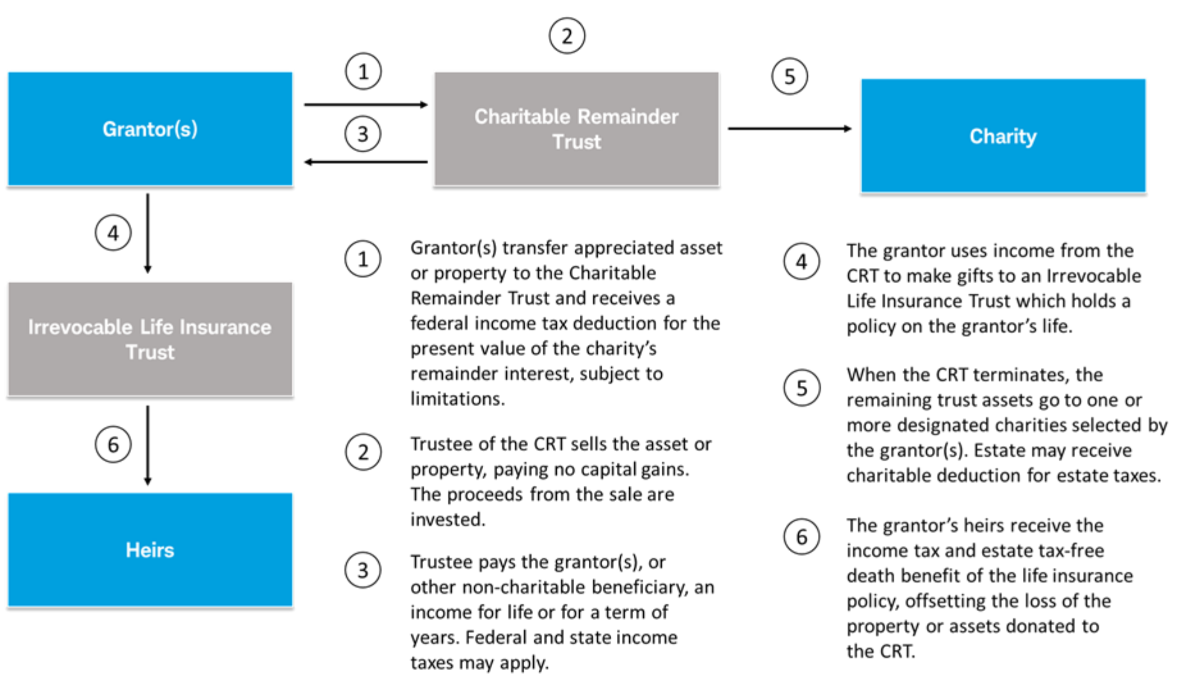
Her income will be taxed based on the ordering procedure above. Assume her $1,000,000 invested in the CRAT grows by $60,000 in her first year ($20,000 in interest income, $15,000 in qualified dividends, and $25,000 in short-term capital gains). Her $50,000 income distribution will first be attributed to $20,000 of ordinary income tax due to interest, the next $15,000 to qualified dividends income, and $15,000 to short-term capital gains.

## Wealth replacement strategy: Combining life insurance with a CRT

Many individuals are hesitant to make significant charitable gifts because they fear the gift may compromise their intended financial legacy to their heirs. A wealth replacement strategy allows high-net worth individuals and families the ability to accomplish both goals: provide for heirs and give to selected charitable organizations.

A wealth replacement strategy uses the income from a charitable remainder trust to purchase a permanent life

**Mechanics of a Wealth Replacement Strategy**




Source: SCFR. For illustrative purposes only.

## Tips for Maximizing a CRT

**Name a donor-advised fund (DAF) as the beneficiary of the CRT for greater flexibility.** The donor can control the amount and timing of the distributions to a charity, advise how the charitable dollars are invested in the DAF, and can change the benefitting charity. For more, visit schwabcharitable.org.

**Make a CRT a beneficiary of an IRA.** Doing this will prolong the distribution to a designated beneficiary who would otherwise have 10 years to distribute assets.

insurance policy in an irrevocable life insurance trust. When the grantor/donor passes away, the heirs get the life insurance death benefit income tax-free from the irrevocable life insurance trust, which is designed to be of equal or greater value than the assets used to fund the CRT. Properly structured, the death benefit of the life insurance policy remains outside of the grantor's taxable estate.

## Bottom line

CRTs can be a powerful planning tool under the right circumstances. For help determining if a CRT would be appropriate for your specific financial circumstances and goals, contact your attorney, CPA, or other trusted financial professional.

**Austin Jarvis, JD**

As Director of Estate, Trust, and HNW Tax for the Schwab Center for Financial Research, Austin provides analysis and insights on topics including complex estate, gift, and trust planning, advanced charitable strategies, business succession, and executive compensation.

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