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Charitable Remainder Trusts and Charitable Annuities as Estate Planning Tools

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This is one in a series of **NebFacts** providing information on the use of estate planning "tools" — mechanisms that can be used in attaining desired estate planning outcomes. Titles in the series are listed following the last narrative section of each document. Reading the documents in this series will improve your understanding of estate planning tools and alternatives, and make it easier to communicate with your attorney, accountant, and other helpers when your estate plan is prepared.

Your need for legal and tax advice: While the information contained in this document is thought to be accurate, it should not be used as a substitute for legal advice on matters related to business organization, taxation, estate planning, gifting of assets, life insurance, or other business and financial management matters. Consult with your legal and tax advisers before making decisions.

Charitable giving often is a priority topic in estate planning. Regardless of their level of income or the value of their estates, many persons desire to make gifts to one or more of the many religious, educational, charitable, or philanthropic organizations and institutions that qualify as charities. Charitable gifts given during a person's lifetime can reduce the giver's estate and subsequently lower estate and inheritance taxes at the time of estate settlement.

Most persons interested in charitable giving also wish to benefit from reduced income tax liabilities during their lifetimes — a benefit that is realized through increased itemized deductions. Itemized deductions for charitable gifts and most deductible expenses currently are deductible to the extent they exceed 2 percent of the taxpayer's federal adjusted gross income. The itemized deduction is reduced as federal adjusted gross income increases above a specified threshold level — currently, \$114,700 for a married couple filing a joint return.

Procedural and reporting requirements for charitable gifts are closely defined in the Internal Revenue Code and Regulations. These requirements must be complied with if the donor is to fully realized the tax benefits of gifting. Informational materials describing the benefits to donors and to the recipient charity

are available from many charities.

This document briefly describes the nature and use of charitable remainder trusts and charitable annuities as two of charitable giving "tools" used for gifts made during the donors' lifetimes. It starts with an overview of tax considerations in charitable giving. A glossary provides definitions of important terms. For more information on trusts, see NF 96-295, *A Trust As An Estate Planning Tool*.

Tax Considerations

Taxation and tax avoidance are important considerations in planning for charitable giving. Subject to applicable limitations, gifts made during the donor's lifetime reduce the donor's total tax load for income, estate, and inheritance tax costs. Gifts made from the donor's estate in the course of estate settlement reduce estate and inheritance tax costs. Considerations on the relative value of present vs. future tax reductions include:

- For income tax purposes, the value for charitable gifts given during the lifetime of the giver is directly deductible from taxable income of taxpayers who itemize deductions, subject to the 50-percent and the 30-percent rules defined in the glossary on page 4 and to the general limitations on itemized deductions noted above. (Gifts of appreciated property are subject to additional limitations linked to the nature of the property and type of recipient charity.)
- For estate tax purposes, the fair market value of a charitable gift from the estate of a deceased person is directly deductible when determining the value of the taxable estate.
- The federal estate tax rate applicable to the taxable portion of an estate starts at 37 percent, a tax rate higher than the income tax rate applicable to many taxpayers.
- For many taxpayers, pre-retirement taxable incomes and tax rates are higher than post-retirement taxable incomes and tax rates. Thus, it often is advantageous to increase income tax deductions during pre-retirement years by taking gift deductions sooner rather than later.
- Because a dollar in hand has greater present value than a dollar to be received in the future, when the tax load is about the same it usually is better to reduce current income tax payments. Estate tax payments that will be payable at some time in the future usually have less present value than current income tax savings and the dollars saved will have earning power during the period prior to estate settlement.

Charitable Gift Decisions

If you are interested in charitable giving using a charitable remainder trust or a charitable annuity arrangement, be sure to consider the financial management record and overall condition of potential recipient charities. A strong record of reliability and sound financial management usually is good reason to believe a charity will use your gift wisely and well. A weak or troubled record of financial management or rating agency reports indicating high overhead costs can be reason to consider other possible recipients. Ask questions, gather information, assess and compare charities. Then make your decision.

Your circumstances and your charitable giving interests and intentions interact in determining whether you'll find the estate planning "tools" described in this document to be useful in your estate planning. Discuss your situation and goals with your legal and tax advisers. Ask them for advice and

recommendations that you can use when thinking about and discussing these issues:

- For what purposes do you want to make charitable gifts?
- What is the nature and amount of assets to be given for charitable purposes?
- Which charity or charities will receive your charitable gifts?
- How many charitable gifts do you want to make — one, several, or many?
- What is to be the timing and amount of each gift?
- What guidance for the use of your charitable gifts do you want to provide?
- What estate planning "tools" are you willing to use in your charitable giving?

In the course of planning your charitable gifts, you'll want to think about and to make decisions on all of these issues. This discussion focuses on only the last of these issues — two estate planning "tools" that often are of interest to persons who intend to use charitable giving in their estate planning.

A Charitable Remainder Trust

Documents establishing a charitable remainder trust (CRT) must be carefully prepared to satisfy the requirements set by applicable portions of the Internal Revenue Code and Regulations. As a split-interest trust (see glossary), the trustee has complete financial management responsibility for the donor's property placed in a CRT. Generally, the trust must qualify as an annuity trust, a unitrust, or a pooled income fund (see glossary). The donor retains an income interest for which he, she, or they receive income payments for a period that generally cannot exceed 20 years, or the remaining lifetime of the income beneficiaries. The charity receives the remainder interest upon termination of the income beneficiary's life interest in the trust assets — usually this occurs upon the death of the beneficiary or beneficiaries.

Starting with the tax year with the CRT is established, the value of the remainder interest qualifies as a charitable gift deduction for purposes of the donor's income tax return. This deduction is subject to the 30-percent rule or the 50-percent rule as applicable according to the nature of the charity receiving the remainder interest. Excess contributions can be carried forward to the donor's income tax returns for up to five years. Any unused charitable deduction lapses at the end of the fifth tax year after the year the trust is established.

The amount of the tax-deductible remainder interest is determined from tables in Internal Revenue Service Publication 1457. Primary determining factors are the age of the income beneficiary or beneficiaries at the time income payments start, the applicable federal interest rate, and the qualification of the trust as an annuity trust, a unitrust, or a pooled income fund. Generally, the size of the remainder interest increases with the age of the beneficiary at the time income payments are to start. For a given age at the time income payments start, the size of the remainder interest is greater when the applicable federal interest rate is lower. When they have data on the type, amount, timing, recipient, and income beneficiary of a proposed gift, your legal and tax advisers can use Publication 1457 tables to provide you with an estimate of the remainder interest value for tax purposes.

Assets placed in a CRT meeting annuity trust or unitrust requirements are not included in the donor's estate for gift or estate tax purposes. If the donor's spouse is an annuity beneficiary, there are no gift or estate tax adverse consequences upon the death of the spouse. The trust assets are included in the spouse's estate and also are deductible from that estate as a charitable gift.

Income earned by an annuity trust or a unitrust CRT is not subject to income tax unless the CRT has business taxable income not related to the charity beneficiary. Payments from the CRT to the annuity

beneficiary generally are taxable as ordinary income or capital gain income (short-term or long-term depending on circumstances). If annuity payments to the donor exceed the earning capacity of assets in the CRT, part of the payment may be nontaxable distribution of the corpus of the trust. There are numerous other specific aspects of charitable giving using a CRT that may or may not be important depending on your situation. Consult your tax and legal advisers before making decisions.

A Charitable Annuity

Charitable annuities are offered by many charitable organizations. In using this form of charitable giving, the owner of assets transfers (donates) them to the charity and the charity agrees to pay the donor or other beneficiary (beneficiaries) a lifetime annuity. The present value of the annuity contract is calculated using Internal Revenue Service tables and varies with the age of the donor and the applicable federal interest rate. A portion of each annuity payment received by the donor is taxable income. The remainder is a nontaxable return of assets.

If the fair market value of assets donated to the charity is greater than the present value of the annuity contract, the donor receives an immediate charitable deduction equivalent to the difference. If the value of the annuity contract exceeds the fair market value of the donated assets, there will be a taxable gain to the donor — a taxable gain that can be avoided by using a charitable remainder trust instead of a charitable annuity.

If the charity has an established charitable annuity program, the donation and establishing of the annuity are easily accomplished. Donors are attracted to charitable annuities when the fair market value of the donation will exceed the value of the annuity contract and the donor is receiving significant levels of taxable income. The certainty of lifetime income in combination with an immediate tax deduction make the charitable annuity particularly attractive.

In circumstances where it's likely a surviving spouse will be unable or unwilling to manage family assets, a charitable annuity or a charitable remainder trust can be a means of ensuring an income stream throughout the remainder of the lifetime of annuity beneficiary or beneficiaries.

Glossary of Terms

The terminology used in describing charitable remainder trusts includes a number of terms with specialized meanings. Several of the most important are briefly defined here:

Contribution base

The base amount used when calculating an individual's or family's maximum allowable tax deduction for contributions made during a tax year. The contribution base is calculated as the individual's (the family's) adjusted gross income before adjustments for net operating loss carryback, if any.

50-percent rule

The rule limiting a taxpayer's charitable deduction for gifts given to a "public charity," a "private operating foundation," or a "private distributing foundation" (see definitions, below). With certain exceptions for gifts of appreciated property, in any tax year this deduction is the amount of the gift up to 50 percent of the donor's contribution base. Gift amounts above the 50 percent limit are carried forward as "excess contributions."

30-percent rule

The rule limiting a taxpayer's charitable deduction for gifts given to a "private foundation" (see definition). In any tax year this deduction is the tax basis of the gift up to

30 percent of the donor's contribution base. (Retroactive to June 1, 1997 and through June 30, 1998, gifts of appreciated publicly-traded stock generally are valued at market value for gift deduction purposes when the stock gift does not exceed 10 percent of the corporation's outstanding stock.) Gift amounts above the 30 percent limit are carried forward as "excess contributions."

Public charity

A charitable organization of a type listed by IRS in Internal Revenue Code § 170(b)(1)(A) (i) through (viii). Gifts to a public charity qualify as charitable deductions for income tax purposes. Organizations such as churches, not-for-profit schools, hospitals, community service organizations, and other similar units are public charities.

Private foundation

A charitable organization that does not qualify as a "public charity" is designated as a private foundation. Gifts to a private foundation are valued at the donor's cost basis rather than the market value of the gift. (See exception under definition of "30-percent rule", above.) Unless a private foundation meets the requirements for designation as a "private operating foundation" or a "private distributing foundation" (defined below), the value of gifts it receives in a given tax year from individual or family donors are tax deductible to the donors in amounts up to 30 percent of the donor's contribution base (the 30-percent rule).

Private operating foundation

A private foundation that's actively engaged in carrying out its charitable purpose. Examples include, operating a public facility or conducting research or education programs. In a given tax year, an individual or family donor to a private operating foundation is entitled to a tax deduction for gifts in amounts up to 50 percent of the donor's contribution base.

Private distributing foundation

A private foundation that serves as a "pass through" for the gifts it receives by distributing each gift to public charities within two and one-half months of receiving the gift. In a given tax year, an individual or family donor to a private operating foundation is entitled to a tax deduction for gifts of up to 50 percent of the donor's contribution base.

Excess contributions

Contributions made during any tax year in excess of the 30 percent rule or the 50 percent rule. Subject to the 30 percent or 50 percent limits, excess contributions can be carried forward and deducted in the five tax years following the tax year when the contribution was made. The maximum amount of the excess contribution deduction is the difference between the donor's current tax year contributions and 50 percent or 30 percent of the donor's contribution base, as determined by the rule applicable to the excess contribution.

Split-interest trust

A trust containing property in which both charitable and noncharitable interests are beneficiaries; a trust that holds property for the benefit of a charity and for the benefit of a person (persons) or entity that's not a charity. In most cases, the noncharitable beneficiary is the donor of property placed in the trust or is a close relative of the donor.

Charitable remainder trust

A split-interest trust in which the remainder interest is held for the benefit of a charitable organization, and the trust meets requirements for classification as an annuity trust, a unitrust, or a pooled income fund.

Charitable income trust

A split-interest trust in which the charitable interest is an income interest for the charity. This trust also must meet requirements for classification as an annuity trust, a unitrust, or a pooled income trust.

Annuity trust

An annuity trust is defined completely in Internal Revenue Code § 664 and its Regulations. In lay language, an annuity trust is one that specifies a fixed dollar amount to be paid at least once a year to the income beneficiary. The minimum payout allowable is 5 percent of the fair market value of the trust property at the time the trust is established. Upon the death of the owner, the balance of the trust goes to the charity.

Unitrust

A split-interest trust similar to an annuity trust in which the annual payment to the annuity beneficiary is based on a fixed percentage of the fair market value of the trust assets when the trust assets are valued annually. (An alternate and less-frequently used form of unitrust limits the annual payment to the actual income earned on the trust assets.) Upon the death of the owner, the balance of the trust goes to the charity.

Pooled income fund

An agreement under which a donor transfers assets to a charity in return for a stream of annual payments based on the value of the donation times the earning rate for all funds held by the charity for investment purposes. The stream of payments continues throughout the remaining lifetime of the beneficiary or beneficiaries, and upon the death of the last surviving beneficiary, the remainder goes to the charity. The remainder interest is a deductible contribution for the donor if certain technical requirements are met.

Documents in This Series:

- NF 95-236, *Nebraska Inheritance and Estate Taxes*
- NF 96-291, *Intestate Succession As An Estate Planning Tool*
- NF 96-292, *A Will As An Estate Planning Tool*
- NF 96-293, *Joint Tenancy As An Estate Planning Tool*
- NF 96-294, *Tenants In Common Ownership As An Estate Planning Tool*
- NF 96-295, *A Trust As An Estate Planning Tool*
- NF 96-296, *Gifting As An Estate Planning Tool*
- NF 96-297, *Life Insurance As An Estate Planning Tool*
- NF 96-299, *Estate Planning Glossary*

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