



CAPE COD
HEALTHCARE
FOUNDATION

Planned Giving

An Investment in Cape Cod's Future

Enhance Your Financial Security with Effective Use of Charitable Remainder Trusts

Life is full of choices. Some, such as the choice of a life partner or a career, determine our future. Others, such as the particular stocks to purchase for our portfolio, affect our future net worth but are generally not life-altering. Still others, such as which restaurant or movie to choose for a night out, are trivial.

A dilemma commonly faced by generous people is how to support a cause in which they believe while also providing security for themselves and heirs. A major charitable gift would appear to diminish the capacity to provide for both oneself and family members.

Fortunately, there is an instrument that may resolve this dilemma. It is, in fact, one of the most versatile of gift vehicles—a **charitable remainder trust** (CRT). With a CRT you place assets in a trust that pays you and/or other individuals income for life or for a period of time, after which the remaining assets are distributed to one or more nonprofit organizations. In addition to an income stream, you are able to retain money that otherwise would have been consumed by taxes.

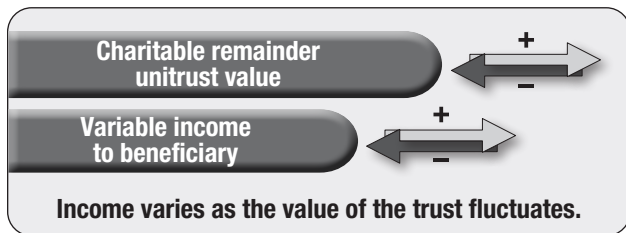
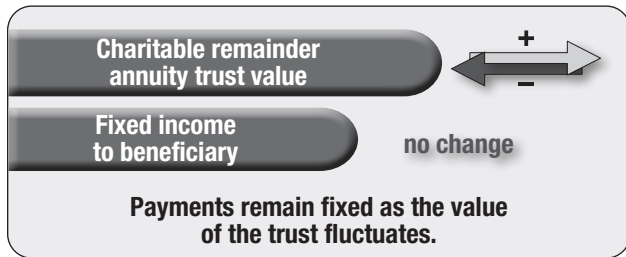
How a CRT Works

Basically, a donor transfers assets to a trust that meets federal requirements. The IRS provides sample trust forms that are guaranteed to be approved if substantially followed. The trustee invests, manages, and distributes the assets according to the terms of the trust document. At the end of the trust, the remaining assets are distributed to the organization(s) specified by the donor.

Payment of benefits: The trustee makes payments according to the trust terms to the beneficiary(ies), as specified by the donor. This stream of income can be designed to last for the lifetimes of the beneficiaries or for a fixed term not to exceed 20 years.

The amount of the payments depends on the type of CRT established. A **charitable remainder annuity trust** (CRAT) pays beneficiaries a *fixed* amount for the entire trust term. The payout must be equal to at least 5% of the initial value of the trust assets. On the other hand, a **charitable remainder unitrust** (CRUT) provides a *variable*

payout. The amount of the payout is a fixed percentage that again must be at least 5% but is a percentage of the value of the trust assets as they change annually.



Example: A 5% unitrust funded with \$100,000 would pay \$5,000 the first year. If the trust appreciates to \$110,000 the second year, the payout will rise to \$5,500.

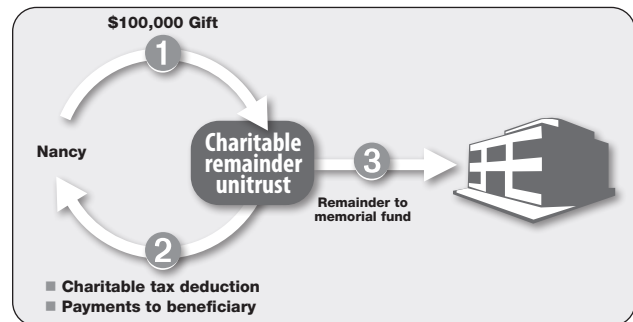
Income-tax charitable deduction: Both unitrusts and annuity trusts generate federal income-tax charitable deductions, based on the present value of the remainder interest that will ultimately pass to us. The remainder interest is determined by reference to several variables. The most important of these are the value of the assets transferred to the trust, the number and ages of the beneficiaries or the length of the trust term, the payout rate, and whether the trust is an annuity trust or a unitrust.

Generally, the size of the deduction is inversely proportional to the payout rate: the higher the rate, the lower the deduction. Likewise, if beneficiaries are young or it is a long-term trust, the deduction will be proportionally lower. Deductions will also be lower if there are multiple beneficiaries.

Example: Nancy K, 72, would like to endow a memorial fund. She has a certain stock she has owned for many years, now valued at \$200,000 with a cost basis of \$60,000. It pays dividends equivalent to a 2% annual

return. Nancy chooses this stock to create a 6% unitrust, naming herself sole income beneficiary for life.

The payments Nancy receives from the unitrust triples the dividends she had been receiving from the stock. In addition to this increase in cash flow, she receives an income-tax charitable deduction of \$83,840, which, given her 24% tax bracket, reduces the income tax she would have paid by approximately \$20,122 during the period she claimed the deduction. Please note that the exact amount you can claim as a charitable deduction depends on two factors: the total amount of your charitable gifts (including the deduction described here) and your adjusted gross income. Also, she avoids the \$21,000 of capital-gain tax she would have paid if she had sold the stock and invested the sales proceeds in higher-yielding securities. (The tax savings could be larger if she lives in a state that has a state income tax and/or she is subject to the 3.8% Affordable Care Act surtax on the capital gain. See below.)



Avoiding tax on capital gain: One of the most important features of both unitrusts and annuity trusts is that they allow a donor to fund a trust with long-term appreciated securities or real estate and avoid recognizing the gain upon the transfer. This is a significant benefit of charitable remainder trusts.

This powerful planning capability gives donors a way to escape “locked-in” positions in investments. Often investors feel forced to hold onto some investments they would rather liquidate because of the potential capital-gain tax. A CRT provides a way to preserve the entire value of an appreciated asset in order to



address personal and charitable objectives without the asset being diminished by capital-gain tax.

Note regarding the 2017 tax act: The Tax Cuts and Jobs Act, signed into law in late December 2017, reduced income-tax rates for most taxpayers. However, it did not reduce the tax rates on capital gains and dividends. Also, it retained the 3.8% Affordable Care Act surtax, which applies to those with adjusted gross income over a certain amount. Upon the sale of appreciated securities, individuals could be subject to a capital-gain rate of 15% or 20%—depending on their level of income; and if the surtax applies, the total tax rate on the gain would be 18.8% or 23.8%. Thus the ability of a person like Nancy to convert appreciated securities to a stream of income without paying an up-front tax on the gain becomes very appealing.

Four tiers of payments: CRT income is taxed in a specific way. Current and accumulated funds are paid out in the following order: ordinary income, capital-gain income, tax-exempt income, principal.

Because of these rules, CRTs can provide favorably taxed income. The assets of the trust could be invested in such a fashion so as to minimize ordinary-income distributions.

Each type of charitable remainder trust offers unique advantages and planning opportunities, which are described below.

The Charitable Remainder Unitrust: Potential Income Growth Plus a Charitable Deduction

The charitable remainder unitrust (CRUT) provides a stream of income that varies with the annual value of the trust principal. If that principal increases in value, income from the trust correspondingly increases. Thus the unitrust appeals to those who seek a hedge against inflation and are willing to accept fluctuations in annual income for the potential of long-term growth.

While a unitrust ordinarily pays a stated percentage of the principal value as determined annually, it can be designed to pay the lesser of that stated percentage and the actual net income of the trust. A unitrust so designed could provide that in any future year when net income exceeds the percentage amount, the excess income can be paid to you to make up for the years when the net income was less than the percentage amount. The extra payment would be limited to the accrued deficiency (that is, the total amounts by which net income fell short of what the percentage payout would have been).

A unitrust that pays the lesser of the stated percentage and actual net income would make sense in two instances:

- You are contributing real estate, and until the property is sold the actual net income is expected to be less than the percentage amount.
- You don't need income now, but you would like to accumulate as much for retirement as possible.

To illustrate the latter situation, imagine that Roger S, 60, transfers stock worth \$200,000—which he purchased years ago for \$50,000—to a unitrust with a 5% payout and a provision that limits the payments to the lesser of this percentage and actual net income until he reaches the age of 70. Then the trust will start paying 5% of the value of trust assets as determined annually.

This gift to support our work generates a charitable deduction of \$72,832, saving him approximately \$25,491 based on a 35% income-tax bracket. If Roger itemizes his deductions, the amount of charitable gifts he can claim is his total contributions minus a floor—which is 0.5% of his adjusted gross income. This floor is the portion of his gifts for which a deduction is not allowed. He also avoids capital-gain tax of \$28,200 that he would have paid if he sold the stock. (The capital-gain tax is based on a 15% rate plus the 3.8% Affordable Care Act surtax.)

Because Roger needs no additional income currently, the trustee invests the trust assets to maximize growth in value—generating only enough dividends to cover trust expenses. Beginning on January 1 of the year immediately after he turns 70, the trust starts paying him 5% of trust

assets. Assuming the value of those assets has grown to \$350,000, he would receive \$17,500 that year. Each year thereafter he will receive 5% of the trust value at the beginning of the year.

The following chart shows representative charitable deductions generated by trusts with various payout rates and beneficiaries of various ages to which \$100,000 of assets have been contributed.

Charitable Deduction for a \$100,000 Gift to a Charitable Remainder Unitrust			
One Life	Payout Rates and Deductions*		
Age	5%	5.5%	6%
55	\$30,595	\$27,568	\$24,910
60	36,416	33,285	30,489
65	43,055	39,911	37,055
70	50,404	47,357	44,544
75	58,305	55,477	52,827
80	66,434	63,946	61,581
85	74,312	72,256	70,276
Two Lives	Payout Rates and Deductions		
Ages	5%	5.5%	6%
55-55	\$21,215	\$18,167	\$15,749
60-60	26,327	23,147	20,372
65-65	32,448	29,110	26,138
70-70	39,607	36,220	33,145
75-75	47,743	44,451	41,405
80-80	56,606	53,570	50,713
85-85	65,682	63,052	60,540

** The exact amount you can claim as a charitable deduction depends on two factors: the total amount of your charitable gifts (including the deduction described here) and your adjusted gross income.*

Augment Current Income

Another attractive benefit of a charitable remainder trust is its ability to increase current spendable income. Depending on the specific asset used to fund the trust, the increase can be quite dramatic.

Investments that have the greatest potential for capital appreciation often produce little or no income. When the time comes to transform the value in the investment to a source of income, there may be capital-gain tax hurdles to clear. By transferring such an asset

to a unitrust, you can create a source of income while keeping the entire value working. When you consider the tax savings, it is possible to improve current cash flow and address your important charitable goals at a minimal cost.

Example: Don and Betty C, ages 74 and 73 respectively, bought some undeveloped land many years ago for \$50,000. It seemed to be in the path of progress, so they have been content to hold it even though it produces no income.

Now the land is worth \$400,000, they have retired, and they would like to capitalize on their good judgment by turning the land into a source of income. If they sell, though, they will pay \$65,800 in capital-gain tax and have just \$334,200 to reinvest. (Again, the tax on the capital gain is based on a 15% rate plus the 3.8% Affordable Care Act surtax.)

They can meet their objectives of increased income and reduced taxes by transferring the property to a charitable remainder unitrust. Like the trust for Roger above, this one will start out paying the lesser of 5% of the value of trust assets and actual net income. However, unlike Roger’s trust that starts paying 5% of the trust value upon the attainment of a certain age, Don and Betty’s trust starts paying the 5% of trust assets the year following the sale of the property—which could be the very next year after the gift if the sale occurs quickly.

The reason for limiting the payment to the lesser of net income and the percentage amount prior to the sale is that the raw land is not generating any income with which to make payments. This is a standard procedure when an illiquid asset is transferred to a unitrust.

The unitrust would also provide an income-tax deduction of \$180,772, saving them approximately \$57,847, assuming they use the deduction in the year they are subject to a 32% tax rate. The remaining trust principal will pass to us after the death of the survivor of them.



Note: Unitrusts also provide options for future planning as well because they can be drafted to allow future contributions—greatly reducing time, expense, and inconvenience if additional gifts seem advisable in the future.

Charitable Remainder Annuity Trust: Security of Fixed Income Plus a Charitable Deduction

Many times, the security of knowing exactly how much income to expect is more important than the possibility of income growth. For those who desire this kind of assurance and are looking for a way to make a significant charitable gift, the charitable remainder annuity trust (CRAT) is an excellent vehicle.

Like the unitrust, it avoids the capital-gain tax on the initial transfer of appreciated assets to the trust. The trust also provides the beneficiary with a fixed stream of income for the life of the beneficiary or a term of years not to exceed 20 years. The annuity trust must equal 5% or more of the initial value of the trust. If its initial value is \$100,000 and the payout is 5%, the distribution the first year—and each year—will be \$5,000.

Applications of an Annuity Trust

An annuity trust can be an appropriate instrument for individuals (mid-70s and older) who have reached the stage of life where the security of fixed payments for life is more important than a hedge against inflation. It also works well when the objective is to provide payments to someone else—for instance, to an elderly parent who needs a subsidy to pay retirement home costs.

Example: Bill and Marge T have been sending Bill's 83-year-old mother \$1,000 per month to cover the difference between her own income and the monthly charge at the retirement home where she lives. Since Bill and Marge are subject to a 35% tax rate, they have to earn \$1,538 pre-tax to have \$1,000 after-tax for the monthly subsidy.

Instead of continuing these gifts, they decide to contribute \$200,000 of a certain stock to a charitable remainder annuity trust that will pay Bill's mother

\$14,000 per year (\$1,167 per month). The stock has performed well—they paid only \$70,000 for it—but the current dividends are only \$3,500 per year.

Bill and Marge receive a charitable deduction of \$115,776, which saves income tax of \$40,522, and they are not taxed on the gain in the stock. Their cash flow increases because they now keep the \$12,000 per year of after-tax income they had been sending while giving up pre-tax dividends of only \$3,500. They do make a taxable gift to Bill's mother of \$84,224 (\$200,000 minus the charitable deduction of \$115,776, but it is highly unlikely they would pay any gift tax because of the very high exemption.

Despite the fact that Bill's mother may pay a modest amount of tax on the income, the trust payments she will be receiving will be comparable to the monthly checks she had been receiving from her son. Upon her death, the remaining trust principal will establish an endowment at our organization named for Bill's parents.

We Are Here to Help

The charitable remainder trust is a wonderfully versatile planning vehicle. We have touched on just a few of the ways you may find one useful for your own situation.

If you have questions about these or any other uses of charitable remainder trusts, we would be delighted to discuss their benefits with you.



Cape Cod Healthcare Foundation
Post Office Box 370 · Hyannis, MA 02601
T: 508-862-5610 · F: 508-790-3532
cmlawson@capecodhealth.org · givetocchc.org