Charitable Remainder Trusts

A Charitable Remainder Trust (CRT) is a tax-exempt, irrevocable trust that allows individuals to convert highly appreciated assets into a potential income stream while ultimately benefiting a charitable organization. CRTs are popular among philanthropically inclined investors and high-net-worth individuals who seek to reduce income taxes, avoid capital gains tax, receive an income stream, and make a charitable gift. Structure and Function

A CRT operates in two phases: the income phase and the charitable remainder phase. When the trust is created, the donor transfers assetstypically appreciated securities, real estate, or other valuable propertyinto the trust. The CRT then sells those assets without incurring capital gains tax due to its tax-exempt status, and reinvests the proceeds to generate income.

During the income phase, the trust pays a stream of income to one or more non-charitable beneficiaries (usually the donor or family members) for a specified periodeither up to 20 years or for the life of the beneficiaries. At the end of the trust term, the charitable remainder phase begins: the remaining assets are transferred to one or more designated charitable organizations.

There are two primary types of CRTs:

Charitable Remainder Annuity Trust (CRAT): Pays a fixed dollar amount annually, regardless of the trusts performance.

Charitable Remainder Unitrust (CRUT): Pays a fixed percentage (minimum 5%) of the trusts annually recalculated value.

Tax Benefits

CRTs offer several substantial tax advantages:

Charitable Income Tax Deduction: The donor receives an immediate income tax deduction in the year the trust is funded. The deduction is based on the present value of the remainder interest ultimately passing to charity, calculated using IRS actuarial tables and the Section 7520 rate.

Capital Gains Tax Deferral: Since the CRT is a tax-exempt entity, it can sell appreciated assets without triggering capital gains tax. This allows the full value of the asset to be reinvested to generate income. Estate Tax Reduction: By removing assets from the donors estate, a CRT can also help reduce estate taxes. However, many donors will establish and fund an Irrevocable Life Insurance Trust (ILIT) to partially or cully replace the value of the assets diverted to charity.

Income Stream: The donor or other beneficiaries receive income during the trust term, which can be beneficial for retirement planning or providing for family members.

Use Cases

CRTs are particularly useful for:

Donors with low-basis, highly appreciated assets looking to diversify.

Those who want to support a charitable cause while maintaining an income stream.

Estate planning strategies aiming to reduce taxable estates and provide for heirs.

Limitations and Considerations

Irrevocable: Once created, a CRT cannot be revoked. The donor relinquishes control over the assets placed in the trust.

Complexity and Costs: CRTs require legal and tax expertise to structure and administer properly, which can incur setup and ongoing administrative costs.

Payout Requirements: The IRS requires that at least 10% of the initial trust value must be expected to go to charity; otherwise, the trust will not qualify.

Deferred Sales Trusts

A Deferred Sales Trust is a financial strategy used to defer (but not avoid) capital gains taxes when selling highly appreciated assets such as businesses or stocks. Unlike a 1031 exchange, which is limited to real estate, a DST can be used for a broader range of assets and provides greater flexibility in how and when the proceeds are reinvested.

How It Works

At the core of a Deferred Sales Trust is the use of a third-party trust to facilitate the sale of an appreciated asset. Heres the general process:

Pre-Sale Transfer: Before a sale occurs, the seller transfers the appreciated asset to the trust (the DST). Trust Sells Asset: The DST then sells the asset to the intended buyer. Because the trust, not the original owner, executes the sale, the capital gains tax is not immediately triggered.

Installment Note Issued: In exchange for the asset, the seller receives an installment note (also known as a promissory note) from the trust, promising to pay the seller over time.

Tax Deferral: Payments to the seller are structured over a period of years, and taxes are only due as principal is received. This spreads out the tax liability and allows the invested proceeds to potentially grow before taxes are paid.

Key Benefits

Capital Gains Tax Deferral: By receiving installment payments rather than a lump sum, the seller can delay the recognition of capital gains, potentially for many years.

Diversification and Liquidity: Unlike a 1031 exchange, which requires reinvestment in like-kind real estate, DST proceeds can be reinvested in a diversified portfolio including stocks, bonds, mutual funds, or even real estate investment trusts (REITs).

Estate Planning Tool: DSTs can be integrated with estate planning strategies, reducing estate tax exposure and offering a way to pass on wealth with more favorable tax treatment.

Flexibility: The payment terms, investment strategies, and trust structure can be customized to suit the sellers risk tolerance, income needs, and tax objectives.

Use Cases

Business owners selling a closely held business.

Real estate investors looking to exit property holdings without engaging in a 1031 exchange.

Individuals selling highly appreciated stocks or collectibles.

Retirees looking to generate a predictable income stream from a sale.

Limitations and Considerations

IRS Scrutiny: Although the DST strategy relies on established tax principles (especially IRC Section 453 regarding installment sales), it is less directly codified than a 1031 exchange, and improper setup may risk IRS challenge.

Setup and Maintenance Costs: Establishing a DST involves legal, trustee, and advisory fees, and ongoing administration costs. It is typically only cost-effective for gains exceeding $500,000.

Trustee Role: The trust must be administered by an independent third-party trustee, and the seller cannot have control over trust assets to maintain the tax-deferral benefit.

No Immediate Access to Funds: The seller gives up ownership of the sale proceeds in exchange for a promissory note, and cannot demand immediate access to the full amount.