

## CHARITABLE REMAINDER TRUSTS: OVERVIEW AND TAX CONSEQUENCES

A charitable remainder trust allows you to make a significant gift to the Outer Banks Community Foundation now, while retaining the right for you and/or your designated beneficiary(ies) to receive a stream of payments over a specified period of time. In general, the specified period may be measured by reference to your life (or that of your designated beneficiary(ies)), may be a fixed period not to exceed 20 years, or may be the shorter of the two. The amount of payments that you and/or your designated beneficiary(ies) will receive during the payment period will depend on how you structure your gift and, to a greater or lesser extent, depending on the terms of your gift, on the investment performance of the assets in your charitable remainder trust.

In establishing a charitable remainder trust, you may transfer cash, securities, and/or other property to a trustee who is responsible for investing and reinvesting these assets, together with any income therefrom, and for making distributions to you and/or your designated beneficiary(ies). The trustee can be the Community Foundation, a bank or other institution or entity, or an individual (including in most circumstances yourself).

When the trust terminates (that is, when it is no longer obligated to make distributions to you and/or your designated beneficiary(ies)), the property remaining in the trust will be distributed to the Community Foundation for its general charitable purposes, or to support a fund of your choosing. You may also specify that the remaining trust property be given to the Community Foundation for endowments to benefit one or more other charities of your choosing.

There are two types of remainder trusts: unitrusts and annuity trusts, which are described briefly below.

*Unitrusts.* In general, a charitable remainder unitrust distributes at least annually to you and/or your designated beneficiary(ies) an amount equal to a fixed percentage of the net asset value of the trust, as determined on the first day of the taxable year. Under such an arrangement, while the percentage is fixed, the value on which it is determined varies from year to year. As a result, unitrust payments increase as the value of the trust assets increase and decrease as the value of the trust assets decreases. You specify at the time you create the trust the percentage of the trust's annual net asset value that is to be distributed each year; the minimum required percentage is 5 percent. You may make additional contributions to a unitrust once it is established.

A unitrust may include a "net income" provision which requires the trustee to pay out the lesser of the trust's net income (defined in some cases to include capital gain) or the specified percentage of net asset value. A net income unitrust may also contain a "make-up" provision that provides that the trustee will "make up" deficiencies in the payments made to you and your designated beneficiary(ies) resulting from the operation of the net income limit. The make-up

operates as follows: If you establish a net income unitrust with a gift of real estate, closely-held stock, or other asset which generates no or a low level of income, the payments made to you or your beneficiary(ies) during the early years of the trust when such asset constitutes the trust's holding will be minimal. A "deficiency" will arise, equal to the difference in the percentage amounts for those years and the income, if any, distributed. If such holdings are later sold and the assets purchased by reinvestment produce an income that exceeds the specified percentage of net asset value in later years, this surplus income will be used to make up the deficiency.

*Annuity Trust.* An annuity trust differs from a unitrust in that its distributions are a fixed percentage of the net asset value of the trust assets as of the date the trust is created. The payout must be equal to at least 5 percent of the initial net asset value, and it must not be so high that, actuarially, it is expected to exhaust the assets of the trust. Following the creation and initial funding of an annuity trust, no additional contributions may be made to the trust.

## **FEDERAL TAX CONSEQUENCES**

*Income Tax.* A charitable remainder trust provides you with an immediate income tax deduction based on the present value of the Community Foundation's remainder interest in your charitable remainder trust's assets. The value of the remainder interest depends on your age (or the age of your beneficiary(ies)) on the date of funding of the trust, the type of trust created, the designated percentage of asset value on which payments to you and/or your beneficiary(ies) will be calculated, the frequency and timing of these payments, and the IRS discount rate in effect at the time.

If you use cash to fund your charitable remainder trust, you are permitted to claim the deduction generated by your contribution to the extent that it, together with the other gifts to public charities made in cash during the taxable year, does not exceed 60 percent of your adjusted gross income for that year. If the value of your combined cash gifts is greater than 60 percent of your adjusted gross income, you can carry over the excess deduction to offset income for up to five years.

If you use appreciated property (held for you for more than a year) to fund your charitable remainder trust, the value of your deduction is based on the full fair market value of such property on the date of contribution. The deduction generated by your contribution, when combined with all other charitable gifts of appreciated property, may not exceed 30 percent of your adjusted gross income for the year of contribution, with a five-year carryover for any excess.

A charitable remainder trust provides an additional income tax benefit when funded with appreciated assets. The remainder trust itself is a tax-exempt entity under federal tax laws. When appreciated assets are sold in the remainder trust, no capital gains tax is paid by the trust. The entire value of your contributed assets can, therefore, be put to work to generate annual distributions; there is no dilution based on asset sales and portfolio turn-over.

The tax treatment of distributions made to you and/or your designated beneficiary(ies) will depend on the type of income earned by the trust. The trust is required to maintain an

historical ledger of income earned and gains realized from year-to-year. Distributions are treated as consisting first of ordinary income (dividends and interest) earned by the trust, then short-term capital gains, then long-term capital gain, then tax-exempt interest, and finally principal. Due to this historic method of accounting, it is not possible for you to donate low-basis or no-basis assets to a remainder trust, have the trustees sell these assets at a gain, and then receive a tax-exempt return from investment in municipal bonds. Tax-exempt income could only be provided once distributions are treated as carrying out all post-gift capital gains.

*Gift and Estate Tax.* If you name individuals other than yourself and your spouse as beneficiary(ies), you may wish to reserve the right to revoke their interest. Otherwise, the value of the interest will be treated as a taxable gift immediately upon funding the trust. If your spouse is the only individual beneficiary (other than you), his or her interest will qualify automatically for the gift and estate tax marital deduction. If the beneficiary is your grandchild or a person who is treated as being two or more generations removed from you, the value of his or her interest may be subject to the generation-skipping transfer tax.

For more information:

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