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Choosing Charity and Children over Congress: A Basic Discussion of Charitable Trusts

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Are you interested in moving a significant amount of assets out of your taxable estate in a manner that would help charity and benefit your children, with little to no estate or gift tax cost? Or are you contemplating selling highly appreciated assets, but you want to save on capital gains, and at the same time help a charitable organization? If either situation applies to you, you might consider talking with an estate planning attorney about implementing a Charitable Trust into your estate plan. The two basic types of Charitable Trusts are discussed below:

Charitable Lead Trusts

With the current federal estate tax exemption[1] expected to plummet, many folks are seeking ways to move assets outside of their taxable estate. There are many ways of accomplishing such task, but if you are charitably minded, it is important to consider a Charitable Lead Trust ("CLT").

CLTs allow you to shift assets outside your taxable estate at little to no gift or estate tax cost. Such assets are moved to a trust designed to hold assets that are "outside" your taxable estate. This means that such assets will not be included when calculating your taxable estate at your death. While, generally, any assets you move to a trust during your lifetime causes you to use up your federal

[1] The federal estate tax exemption is the amount that can pass free of federal estate tax. The exemption is currently $12,060,000 but will revert to $5,600,000 as of January 1, 2026 (if not sooner, subject to changes by Congress).

gift tax exemption[2], which in turn has negative estate tax consequences, CLTs allow you to make such transfer while using very little of your federal gift tax exemption, thereby allowing you to save on estate taxes at your death.

A CLT is a "split-interest" trust. After transferring assets to the CLT, the trust provides a "lead interest" either in the form or an annuity or unitrust amount. Such "lead" amount is distributed annually to a charitable organization for a term of years. After the term of years expires, the remainder interest passes to non-charitable persons, usually the trust maker's children.

CLTs can be drafted several different ways. They can be structured so that the trust pays any income taxes or so that the trust maker pays the income tax. CLTs are not tax exempt. In addition, CLTs can be implemented during the trust maker's lifetime or after his or her death.

Below is an example of a CLT made during the trust maker's lifetime:

Jacob Busser is concerned about his estate being subject to estate tax at his death and is therefore interested in giving his wealth to his children at little to no gift tax. Since he already contributes significantly to his church, Jacob implements a CLT that pays a lead interest of $25,000 a year to his church for 15 years. After 15 years, Jacob's children, Effie and Elsie, receive the remainder.

Jacob funds the CLT with $500,000. Ordinarily, Jacob would use $500,000 of his gift tax exemption[3], thereby potentially exposing more of his estate to estate tax at his death. However, only the present value of his children's future interest in the trust will be counted against him for gift tax purposes. Using the Sect. 7520 rate of 2%, Jacob will only use up $176,358.26 of his gift tax exemption, thereby potentially saving him on estate taxes at his death.

The above example is merely a hypothetical scenario and should not be construed as legal advice. CLTs are complicated trust structures, and discussions should be had with your trusted attorney and financial advisor before implementing a CLT into your estate plan.

Charitable Remainder Trusts

Charitable Remainder Trusts ("CRTs") involve more income tax planning than federal estate and gift tax planning. CRTs pay an income interest to non-charitable beneficiaries, with the remainder passing to a charity. CRTs are tax exempt. Such tax exempt status allows them to be incredible tools for income tax planning purposes.

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[2] The federal gift tax exemption is equal to the federal estate tax exemption. To the extent the gift tax exemption is used during one's lifetime, his or her estate tax exemption will be lost respectively.

[3] The Annual Gift Tax Exclusion ($16,000 per recipient in 2022) does not apply to gifts to CLTs.

CRTs can be drafted in different ways. They can be established for the life or lives of a person or persons. Or they can be for a term of years (not to exceed 20). The value of the charity's remainder interest must be at least 10% of the net fair market value of the assets transferred to the CRT.

Even though CRTs are tax exempt, meaning there are no income taxes on income generated on any assets held in a CRT, any distributions to the non-charitable lead beneficiaries are taxable. CRTs can be uniquely drafted so that such distributions can be deferred, allowing the non-charitable beneficiary to defer income taxes. CRTs established to defer income taxes allow the client to both defer income taxes and enjoy the tax-free growth of the assets inside the trust.

CRTs are attractive for clients who are going to sell a highly appreciated asset. If, for example, a client transfers a stock portfolio with unrealized gain to a CRT, a sale inside the CRT will not generate income tax. The client can then potentially receive distributions from the portfolio for his or her lifetime. And depending on the how the CRT is structured, the client may defer distributions until much later. Distributions are taxable, but the client may choose to receive distributions at a time when he or she is in a lower tax bracket. Such uniquely crafted CRT could act as an additional retirement account for the client, a tool that is very helpful for clients whose income exceeds their ability to participate in a Roth IRA.

CRTs are complex trust structures and discussions should be had with your trusted attorney and financial advisor before implementing a CRT into your estate plan.

About the Author

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