

Supplementing Retirement Income with a CRT

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The Concept

- In recent years, stock market volatility, government limitations on retirement contributions, low interest rates and even concerns about Social Security have many people looking for ways to supplement retirement income.
- More and more people are discovering that they can increase retirement income through what may seem an unlikely source—charitable gifts.
- Charitable gift arrangements known as “life income gifts” pay an income back to the donor.
- Life income gifts enable individuals to donate highly appreciated assets that produce little or no income, and get back a stream of income that can last for the donor’s life or the lives of two or more people.
- The charitable remainder trust is an effective and popular form of life income gift.

Trusts

- There are two types of charitable remainder trusts: the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT).
- A CRAT has the same annual payout each year based on a percentage of original trust assets.
- The annual payout of the CRUT varies, since it is based on a percentage of the trust assets as they are revalued annually.

Variations

- There is only one type of CRAT, while there are several variations of CRUTs. Its flexibility often makes the CRUT a good option for supplementing retirement income.
- A straight CRUT pays out a percentage of the trust assets as measured from year to year.
- A net-income CRUT pays either a percentage of the trust assets as measured from year to year or the net income produced by the CRUT, whichever amount is less.
- A net-income CRUT with a make-up provision (also known as a NIMCRUT) allows the trustee to keep track of the payout deficits—the difference between a straight payout and the net income. In future years, when the trust earns more income than could be distributed by the straight payout rate, the trustee can increase the payout by drawing on the past payout deficits. These enhanced “make-up” payments can be timed to coincide with a beneficiary’s retirement income needs.
- A “flip” CRUT is, at the outset, a net-income CRUT that pays the lesser of income or the payout rate on the annually revalued trust assets. If a donor funds the CRUT with illiquid assets, no payments are required because there is no income. But when the trustee sells the assets, the CRUT “flips” into a straight CRUT that makes payments. The trustee invests the proceeds from the sale of the assets into income-producing investments so that the income can be used to make annual payments.

- The triggering event that causes the CRUT to flip does not have to be the sale of assets—it could be a specific date, the marriage of a beneficiary, the birth of a child, etc. However, the IRS requires that the triggering event be outside the control or discretion of the donor, trustee, income beneficiary, or any other person. Therefore, only the sale of unmarketable assets can trigger the flip (as the sale of marketable assets puts the timing of the flip within the trustee’s control).

Important to Note

- The donor can fund the NIMCRUT or flip unitrust with a non-income-producing asset, such as real estate.
- In the year of the gift, the donor qualifies for an income tax charitable deduction based on the present value of the charity’s remainder interest, with any excess deduction amount to be used in up to five following years.
- The donor does not incur capital gains tax when the appreciated property is transferred to the trust.
- The NIMCRUT or flip unitrust trustee holds the non-income-producing assets contributed to the trust—or invests in assets that produce little or no income—until the donor reaches retirement age.
- When the donor retires, the trustee converts the assets into income-producing investments and begins the income payouts.
- The donor isn’t subject to nondiscrimination rules or other government restrictions and limitations that apply to qualified retirement plans.
- At the trust’s expiration, the trust property is distributed to the charitable organization.

Potential Downsides

Before setting up a CRT, donors should carefully consider that CRTs are:

- **Irrevocable.** The donor has no control over the assets once they are transferred into the trust.
- **Complex.** Professional services are necessary to ensure compliance with all rules and requirements, which adds another layer of expense and makes them best suited for substantial gifts. Donors wishing to make smaller gifts should consider whether a charitable gift annuity or other simpler gift option might be a better fit.
- **Gifts.** Yes, these gifts come with tax and income benefits, but if the IRS believes a donor is misusing a CRT to evade taxes or hide capital gains, the consequences can be severe.

The Bottom Line

A charitably inclined individual can make use of the flexibility of trusts to accomplish the twin goals of enhancing retirement income and making a substantial gift to charity.

Summary

More and more individuals are discovering a way to increase retirement income using an unlikely source: charitable gifts. These gifts are called “life income gifts” because they pay an income back to the donor. Life income gifts enable people to transform highly appreciated assets that produce little or no income into charitable gifts, and also receive an income stream that can last for life or for the joint lives of two or more people.

What’s a CRT?

A charitable remainder trust is a “split-interest” trust that pays an income to the donor (or someone chosen by the donor) for a number of years, then distributes the remainder of the trust assets to charity. The income payout to non-charitable beneficiaries may last for up to 20 years or for the lifetime of the beneficiaries.

CRTs come in many different forms, but two particular ones are best suited to create retirement income—the net income charitable remainder unitrust with a make-up provision (NIMCRUT) and the “flip” unitrust.

What’s a NIMCRUT?

A charitable remainder unitrust is unique in that it pays the income beneficiary—usually the donor—a fixed percentage of the trust assets as revalued every year. If the trust income in any given year isn’t enough to make the payout, the trustee is forced to invade the trust principal unless the trust design includes a “net income limitation.” Such a limitation allows the trust to pay the lesser of the trust’s net income or the fixed percentage.

The net income unitrust with a makeup provision, or NIMCRUT, lets the trust make up payout deficits in later years of the trust.

What’s a “Flip” Unitrust?

A “flip” unitrust contains special language in the trust document that allows a net income unitrust (with or without the makeup provision) to “flip” or change to a straight unitrust on a specific date or upon the occurrence of an event, such as a sale of the assets originally contributed to the trust.

The “flip” option is particularly useful to donors who contribute real estate, closely held stock or some other non-income-producing asset to the trust. The net income limitation disappears after the illiquid asset is sold, which can be designed to match the donor/beneficiary’s expected retirement date.

What’s the Process?

The donor begins by funding the “flip” unitrust with a non-income-producing asset, such as real estate. In the year of the gift, the donor who itemizes receives an income tax charitable deduction based on the present value of the charity’s remainder interest in the trust.

The trustee holds the non-income-producing assets contributed to the trust or invests in assets that produce little or no income until the donor reaches retirement age. Then, the trustee converts the assets into income-producing investments and begins the income payouts. When the trust expires, trust property is distributed to the charitable organization.

Are there downsides?

Potentially, yes. Before setting up a CRT, donors should carefully consider that the trust is irrevocable and complex, typically requiring a substantial gift and the expense of professional services to ensure compliance with all rules and regulations. If the IRS believes a CRT is being misused for tax evasion purposes, it will result in severe consequences.

Conclusion: Flexibility

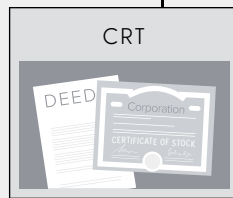
For those who are charitably inclined, adding the well-known flexibility of charitable remainder trusts to a donor's charitable motivations can accomplish the twin goals of enhancing retirement income while also making a substantial gift to charity.

1

The donor irrevocably transfers cash or property to a charitable remainder trust. The donor qualifies for a federal income tax charitable deduction for the present value of the charity's remainder interest, subject to limitations.



DONOR



2

The donor receives income distributions from the CRT, which can be timed to begin immediately or at some specified future time.

3

These income distributions from the CRT supplement retirement income the donor receives from other potential sources: Social Security, employer retirement accounts, personally owned IRAs, and other savings and investments.

4

The charity receives the remainder when the trust term expires.



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