

T H E C H A R I T A B L E
R E M A I N D E R
U N I T R U S T

Maximize the Benefits of Your Estate Plan

a donor's guide

© The Stelter Company

THE CHARITABLE REMAINDER UNITRUST
**Maximize the Benefits of Your
Estate Plan**

Typically, people focus a tremendous amount of energy on increasing the rate of return on their investments when, in reality, this is the one aspect of their estate over which they have the least control. Where you can make an important difference, however, is in the amount of your estate you surrender to taxes. Unfortunately, many people overlook this opportunity.

A charitable remainder unitrust is one such technique that can reduce taxes and address a number of other estate planning challenges.

The Charitable Remainder Unitrust

A unitrust is created when the donor transfers assets to the trust that pays an annual income to one or more beneficiaries for their lives or for a term of years (not to exceed 20) and pays the remainder to charitable organizations. If the assets used to fund the trust are appreciated, the trustee may sell them free of capital gains tax and invest the full fair market value.

Each year, the trust pays the trust beneficiaries an income equal to a fixed percentage of the trust's net asset value. This means that annual income paid by the trust could increase in proportion to any increase in the value of the trust principal or, conversely, decrease with diminishing value of the trust assets.

Since the unitrust is an irrevocable charitable gift, the donor receives an income tax deduction. This deduction reduces the

cost of establishing the trust and may also increase the donor's income over that generated by the contributed assets.

Unitrust income can be structured in four ways. The first is the "regular" payment unitrust, which makes payments to the income beneficiaries at the rate specified in the trust agreement, even if invasion of the trust principal is required.

A second type of unitrust, called a net income unitrust, pays the donor the lesser of the fixed percentage or actual trust income, but without the makeup provision. It is used by donors who want to contribute non-income-producing property to the trust and maximize the benefits to a charitable organization.

A third variation is a net income with makeup unitrust. The trust pays the lesser of the fixed percentage specified by the trust agreement or the actual trust income. Such trusts provide, however, that in any year the trust income exceeds the fixed percentage payout, the excess must be used to make up any prior deficiencies. It offers great flexibility in retirement planning because income can effectively be deferred until later years.

A final form of the unitrust, the flip trust, is a trust that begins as a net income or net income with makeup unitrust and "flips" or changes to a regular payment unitrust during the term of the trust.

As with any charitable remainder trust, upon the death of the final income beneficiary, the unitrust principal passes to the charitable organization the donor selected when the trust was established. It is this deferred gift to a charitable organization(s) that creates the charitable deduction.

Illustration of Unitrust Results

Sharon and Bob, ages 65 and 63, respectively, are in the 28 percent tax bracket and will have a taxable estate at the second death. They own stock valued at \$300,000, for which they paid \$75,000 15 years ago. The stock pays an annual dividend of \$9,000.

With Bob about to retire, the couple decide that these assets should be reinvested in securities paying better than a 3 percent return. If they sell this stock for \$300,000, however, they will incur a federal capital gains tax (at 15 percent) of \$33,750. To avoid losing the use of this income-producing property, they decide to combine their retirement income objective with a charitable interest.

They decide to create a two-life, 5 percent charitable remainder unitrust using a net income with makeup provision. The 5 percent payout increases the income received from the assets and generates an income tax deduction, while the net income plus makeup provision protects the principal and remainder interest. If appropriate, the trustee can employ an investment strategy that will provide for growth with minimum income during Bob and Sharon's working years, then change assets to produce more income during their retirement years.

Results of Two-Life Unitrust Gift

	Stock Sold By Donor	Stock Contributed To Trust
Market value of stock	\$300,000	\$300,000
Cost basis in stock	(75,000)	
Capital gain when sold	\$225,000	
Tax at 15% rate	(33,750)	
Charitable deduction ¹		\$101,211

Tax Savings to Donor

Gift Value	\$300,000
Capital gains savings	(33,750)
Income tax (assumes full use of deduction and 28% tax rate)	(28,339)
Net cost of gift	\$237,911
First year trust payment:	\$15,000

¹All deductions in this brochure are based on quarterly payments and a 4.6% charitable midterm federal rate.

The unitrust solves three significant problems by:

1. Increasing income from current assets.
2. Allowing the couple to avoid capital gains on the sale of the assets.
3. Reducing estate taxes (at the death of Sharon and Bob) as a result of the charitable deduction when the remainder interest passes to the charitable organization.

A Trust for Many Purposes

John Benson, 58, and his wife Margaret, 56, are planning their estate and have an estate of \$3 million: a home appraised at \$650,000 (cost basis of \$100,000); a stock portfolio valued at \$700,000 (cost basis of \$400,000); John's pension plan (current value of \$1.5 million); and savings of \$150,000. Having met with their financial advisors, they know they need to prepare for the years ahead and would like to include a gift to charitable organizations, if possible.

When John and Margaret look at the options available to create current income and reduce future taxes, they see few options. Their stock portfolio is yielding only 4 percent (\$28,000), and they would like to increase their income stream, especially since their income-earning years are so limited. If they sell their stocks to reinvest, they will pay capital gains of \$45,000 (assuming a 15 percent federal capital gains tax rate), reducing the net proceeds to \$655,000. Reinvesting this amount at 5 percent will yield only \$32,750.

John's pension plan now has assets of \$1.5 million. Although he is anxious to create additional income in retirement, he is aware that any assets remaining in the plan at his death will be subject to income taxes as well as estate taxes.

John and Margaret also want to leave as much as they can to their children and grandchildren. They plan to maximize their estate planning options by funding a credit shelter trust to take advantage of the tax exclusion that allows each of them to

transfer up to \$1.5 million (in 2004 and 2005) to heirs free of estate tax. If they plan their estates so that they both maximize use of this option, they can shelter most or all of their assets from tax. But if they do no planning, they may pay estate taxes.

Results of No Estate Planning²

	Expenses And Tax	Assets to Family
Estate of second to die	\$3,000,000	
Settlement costs (3%)	(90,000)	
Net taxable estate	\$2,910,000	
Exclusion Amount	(1,500,000)	\$1,500,000
Estate tax	(661,800)	
Balance	\$748,200	\$748,200
Net to family		\$2,248,200

²Assuming death occurs in 2003.

Transfer of Securities to a Unitrust

One option to increase current income and meet long-term charitable goals is to transfer a portion of their securities to a charitable remainder unitrust that will pay 5 percent of the trust's annual value to John and Margaret for their lifetimes. The example below shows the benefits to the Bensons of transferring \$250,000 in securities to the unitrust.

Results of Unitrust

	Trust Result	Net Cost Of Gift
Transferred to unitrust	\$250,000	\$250,000
Capital gains tax avoided (\$107,150 gain x 15%)		(16,073)
Charitable income tax deduction (assumes full use and 35% tax rate)	\$63,508	(22,228)
Amount invested by trust	\$250,000	
Net cost of gift		\$211,699
First-year trust income	\$12,500	

With the tax savings, John and Margaret could purchase a survivorship (second-to-die) life insurance policy to replace that portion of the value of the securities that have been placed in the unitrust. The death benefit (\$300,000) will pass to the children.

By making their children both owners and beneficiaries of the insurance, or by creating an irrevocable life insurance trust (sometimes known as a wealth replacement trust) to own the policy, the couple can keep the life insurance out of their estate, where it would otherwise be taxed if John or Margaret owned the policy. If a trust is used, the children are named the beneficiaries of the trust, so that the policy proceeds pass to them at the death of their parents.

The Retirement Plan Supplement

John and Margaret are concerned about building sufficient assets

for retirement and protecting any assets remaining at the death of the survivor from income and estate taxes. One solution is to have John make an annual contribution to a unitrust that uses a net income with makeup provision. John's contributions are not subject to the limits on contributions to qualified retirement plans and provide a charitable income tax deduction in years when his income is high.

The trust will begin to make distributions immediately, but those distributions will be small so long as the trustee invests the assets for long-term growth. Once John retires, the trustee can change the trust to generate more income, adding a supplemental income stream to his retirement plan distributions. Since John likely received less than the 5 percent distribution during his working years, he may receive more than 5 percent (up to the amount of prior years' undistributed amounts) in years in which the trust generates more.

If assets remain in the retirement plan at the death of the survivor of John and Margaret, the remaining assets can be protected from the majority of the income and estate tax due by naming a second unitrust as the beneficiary of the retirement plan. This trust not only reduces the tax on remaining retirement assets, but can also provide income to the children and a significant benefit to a charitable organization like ours.

Add Up the Benefits

The charitable remainder unitrust opens the door to beneficial planning alternatives, as well as a significant contribution to our organization.

For donors, a charitable remainder unitrust avoids capital gains tax on the sale of highly appreciated assets while providing the donors with tax-free cash. It provides income for one or more lives, either now or later, and results in a reduction in estate taxes at the death of the income beneficiaries.

We would be happy to show you how the ideas presented in this brochure could fit your particular circumstances—at no obligation.

The information in this publication is not intended as legal advice. For legal advice, please consult an attorney. Figures cited in examples are based on current rates at the time of printing and are subject to change. References to estate and income tax include federal taxes only; individual state taxes may further impact results.

© The Stelter Company