



Charitable Remainder Trusts (CRTs) Overview



A CRT is a tax-exempt, irrevocable trust designed to convert highly appreciated assets into a lifetime income stream without triggering immediate capital gains taxes. It is known as a “split-interest” vehicle because it separates the asset’s economic value into two distinct parts:

The Income Interest

A stream of annual payments made to you (the beneficiary) for a set term or for life.

The Remainder Interest

The principal remaining in the trust at the end of the term, which passes to your chosen charity.

In essence, it allows investors to sell an asset tax-free, reinvest the full gross proceeds, and benefit from the compound growth of tax-deferred capital, all while securing a future philanthropic gift.

The Ideal Candidate: Who Fits the Profile?

A Charitable Remainder Trust is not merely a philanthropic vehicle; it is a powerful tax-deferral and asset-diversification tool. The ideal candidate typically fits the following profile:

Holders of Highly Appreciated Assets:

Individuals holding assets with a very low cost basis (such as zero-basis stock, founder’s equity, real estate, or art) who wish to sell without triggering an immediate capital gains tax event, which could otherwise erode a significant portion of the principal.

Income Seekers:

Individuals looking to convert a non-income-producing asset (like raw land or growth stock) into a steady lifetime income stream.

Legacy Planners:

Families concerned with estate tax exposure who want to remove assets from their taxable estate while retaining the economic benefit (income) from those assets.

Types of CRTs: A Comparative Overview

Choosing the right “chassis” for the trust is the most critical design decision.

Type	Full Name	Mechanism	Best Use Case
CRAT	Charitable Remainder Annuity Trust	Pays a fixed dollar amount every year. No additional contributions allowed.	Investors who want bond-like reliability and fear market downturns.
Standard CRUT	Charitable Remainder Unitrust	Pays a fixed percentage of the trust's value, revalued annually.	Investors who want an inflation hedge. If the portfolio goes up, the payout check goes up.
NIMCRUT	Net Income with Makeup CRUT	Pays the lesser of the fixed percentage or the actual income produced. Deficits are tracked and paid in future years if income spikes.	You can invest in low-income growth assets now (taking low payouts) and switch to high-yield assets later to trigger "makeup" payments.
Flip-CRUT	Flip Charitable Remainder Unitrust	Starts as a NIMCRUT (paying only actual income) and "flips" to a Standard CRUT upon a triggering event (e.g., sale of a property).	Essential for illiquid assets such as real estate or private business interests that may not sell immediately. Prevents the trust from being forced to sell assets at a fire sale to pay the beneficiary.

History of CRTs and Regulatory Framework

Prior to the late 1960s, charitable trusts were loosely regulated, often allowing donors to take aggressive deductions for gifts that charities might never actually receive. Major legislative reforms in 1969 formalized the CRT structure. Taxpayers may receive an immediate tax deduction and tax-deferred growth, provided the trust is structured rigidly to ensure the charity eventually receives a measurable benefit.

The Charitable Remainder Trust is a statutory entity defined by federal law. Its legal existence and associated tax benefits are rigorously governed by Internal Revenue Code (IRC) § 664.

The tax-exempt status of the CRT is codified in IRC § 664(c)(1). This section explicitly mandates that a valid Charitable Remainder Trust “shall not be subject to any tax imposed by this subtitle” (referring to Federal Income Tax). This exemption allows for the tax-free sale of appreciated assets. However, to maintain this qualified status, the trust must operate within specific statutory “guardrails”.

The 10% Remainder Rule:

- **The Regulation:** IRC § 664(d)(1)(D) (for Annuity Trusts) and IRC § 664(d)(2)(D) (for Unitrusts).
- **The Rule:** At the trust's inception, the calculated present value of the remainder interest (what the charity is projected to receive) must be at least 10% of the net fair market value of the property contributed. If a contribution fails this test, the trust is not a valid CRT.

The 5% Minimum Payout Rule:

- **The Regulation:** IRC § 664(d)(1)(A) (for Annuity Trusts) and IRC § 664(d)(2)(A) (for Unitrusts).
- **The Rule:** The annual payout to the non-charitable beneficiary must not be less than 5% of the trust assets (valued initially for CRATs, or annually for CRUTs).

The 50% Maximum Payout Rule:

- **The Regulation:** IRC § 664(d)(1)(A) (for Annuity Trusts) and IRC § 664(d)(2)(A) (for Unitrusts).
- **The Rule:** The annual payout to the non-charitable beneficiary generally cannot exceed 50% of the trust assets. (This cap was introduced by the Taxpayer Relief Act of 1997 to prevent "churning" schemes.)

Probability of Exhaustion Test (CRATs Only):

- **The Regulation:** Revenue Ruling 77-374 and Treas. Reg. § 1.7520-3(b)(2).
- **The Rule:** Even if a CRAT passes the 10% Remainder Rule, it must also pass the "5% Probability Test." The IRS will disallow the charitable deduction if there is a greater than 5% actuarial probability that the trust funds will be exhausted before the charity receives its remainder.
- **Note on Compliance:** To ensure this test is never failed, trusts often include specific "Safe Harbor" language authorized by Revenue Procedure 2016-42. If the trust drops to 10% of its initial funding amount, the trust terminates immediately. The beneficiary gets nothing more, and the remaining 10% goes to the charity.

Calculations Summary Table

Calculation	CRAT (Annuity)	CRUT (Unitrust)
10% Remainder Test	Year 1 Only	Year 1 (and any time you add new money)
5% Probability Test	Year 1 Only	N/A
Beneficiary Payout Amount	Fixed Forever (Calc in Year 1)	Re-Calculated Annually
"Safe Harbor" Test (if included)	Calculated Annually	N/A

The CRT Roadmap: Key Decisions & Execution Cycle

Creating a Charitable Remainder Trust requires a two-step approach: first, navigating a complex “Decision Matrix” to design the vehicle, and second, adhering to a strict procedural lifecycle to establish and administer it.

Phase 1: The Design Matrix

Before a single legal document is drafted, the donor must make irrevocable decisions that define the trust’s legal structure and economic performance.

1. Structural Decisions

- **Trust Type:**
 - **CRAT (Annuity):** Pays a fixed dollar amount.
 - **CRUT (Unitrust):** Pays a fixed percentage.
- **The Sub-Type (If CRUT selected):**
 - **Standard:** Pays out a fixed % regardless of income.
 - **NIMCRUT:** Pays the lesser of income or percentage (allows deferral).
 - **Flip-CRUT:** Starts as NIMCRUT, flips to Standard upon a sale (required for illiquid assets).

2. Financial Parameters

- **Payout Rate:** Must be between 5% and 50%. A higher rate increases income but decreases the charitable deduction; a lower rate allows for more tax-free compounding.
- **Payout Frequency:** Monthly, Quarterly, or Annually (Note: End-of-year payments typically yield a slightly higher tax deduction.)
- **The Term:** Fixed Term (Max 20 years) or the Lifetime of the beneficiary or beneficiaries.

3. Personnel & Beneficiaries

- **The Trustee:**
 - Donor: Low cost and high control, but carries strict liability risks.
 - Corporate: Professional compliance and liability protection, but higher fees.
- **The Beneficiaries:**
 - Income Beneficiary: Typically, the Donor and Spouse. (Warning: Naming a non-spouse beneficiary triggers Gift Tax implications.)
 - Charitable Beneficiary: Public Charity vs. Private Foundation. (Note: Funding a Private Foundation reduces the deduction limit from 30% to 20% of AGI.)

Phase 2: The Execution Lifecycle

Once the design parameters are defined, the lifecycle of a CRT follows a strict procedural flow to ensure compliance with IRS regulations.

1. Drafting:

An attorney drafts the irrevocable trust agreement, ensuring it complies with federal standards (IRC § 664). This document incorporates the structural decisions made in Phase 1 (Payout rate, Trustee powers, Spendthrift clauses).

2. Funding:

The grantor transfers the asset into the trust.

- **Crucial Timing Rule:** This must happen before there is a binding legal obligation to sell the asset to a buyer. If a sale is already "locked in" before funding, the IRS may apply the "Assignment of Income" doctrine, forcing the donor to pay the taxes personally.

3. Appraisal:

If funding the trust with "hard-to-value" assets (such as real estate, private stock, or artwork), a Qualified Independent Appraisal is required to substantiate the income tax deduction. This value is reported on IRS Form 8283.

4. The Sale:

The Trustee sells the asset. Because the trust is tax-exempt, \$0 capital gains tax is paid. The full gross proceeds (undiminished by tax) are available for immediate reinvestment into a diversified portfolio.

5. Administration:

The trust enters its operational phase. The Trustee must:

- File Form 5227 annually (an informational return to the IRS).
- Issue Schedule K-1 to the beneficiary to report the tax character of the income received (Ordinary Income vs. Capital Gains vs. Principal).

Taxation of CRT Payouts

The “Tier System” of Taxation:

CRT income is taxed under a “Worst-In, First-Out” logic:

Tier 1:	Ordinary Income - Taxed at the highest rates.
Tier 2:	Capital Gains - Taxed at more favorable rates.
Tier 3:	Tax-Exempt Income - Tax free.
Tier 4:	Return of Principal - Tax free.

You cannot touch the next tier until you have exhausted the income from the higher tiers.



The “Wealth Replacement” Strategy (Family Maximization)

Can a CRT make sense even if your primary goal is preserving wealth for your children rather than philanthropy? Yes.

This strategy, known as the “Wealth Replacement Trust,” is a form of tax arbitrage. It uses the tax savings generated by the CRT to fund a tax-free inheritance for your heirs, often resulting in a greater net transfer than a simple sale.

The Problem: A CRT legally disinherits your children; the remainder interest goes to charity, not your family.

The Solution: You utilize the “excess” cash flow created by the strategy—specifically the upfront income tax deduction and the capital gains tax savings—to fund an Irrevocable Life Insurance Trust (ILIT) for your children.

The Result:

1	2	3
You receive a higher lifetime income stream (generated by the pre-tax gross proceeds.)	The Charity receives the trust remainder.	Your Heirs receive the Life Insurance death benefit free of both Income Tax and Estate Tax.

The Arbitrage: Effectively, you are redirecting the money you would have paid to the IRS in taxes to pay the premiums on a policy that provides your children’s inheritance.

The Winning Configuration

To maximize the benefit to your heirs (and minimize the leakage of principal), the trust must be tuned for "Growth" rather than "Yield."

Variable	Optimized Setting	Why this works
Trust Type	Standard CRUT	Inflation protection. A CRUT pays a percentage of the current market value. As the portfolio grows, your payout amount grows. This creates an increasing income stream to pay rising insurance premiums or combat inflation. (A CRAT's fixed payment loses purchasing power over time.)
Payout Rate	Low (5% - 6%)	The "Growth Gap." You want the Payout Rate to be lower than the Investment Return (e.g., Pay 5%, Earn 7%). This causes the trust principal to grow tax-free, which mathematically compounds your future income. A high payout rate cannibalizes the principal and hurts the long-term math.
Term	Lifetime	Maximum deferral. You want to maintain the tax-free compounding environment for as long as possible to maximize the "interest-free loan" from the government.
Investment	Total Return (Stocks)	Tax-free rebalancing. Since the trust pays no capital gains tax, you can invest aggressively in high-growth strategies. You are not penalized for turnover, allowing for a pure total return strategy.



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